



# Fixing Public Sector Finances: The Accounting and Reporting Lever

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## Fixing Public Sector Finances: The Accounting and Reporting Lever

James Naughton & Holger Spamann



### ABSTRACT

The finances of many states, cities, and other localities are in dire straits. In this Article, we argue that partial responsibility for this situation lies with the outdated and ineffective financial reporting regime for public entities. Ineffective reporting has obscured and continues to obscure the extent of municipal financial problems, thus delaying or even preventing corrective actions. Worse, ineffective reporting has created incentives for accounting gimmicks that have directly contributed to the dramatic decline of public sector finances. Fixing the reporting regime is thus a necessary first step toward fiscal recovery. We provide concrete examples of advisable changes in accounting rules and advocate for institutional changes, particularly Securities and Exchange Commission involvement, that we hope will lead to better public accounting rules generally.

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## INTRODUCTION

Detroit's recent bankruptcy filing highlighted what savvy observers have been warning about for years: The finances of many states, cities, and other localities, collectively referred to as municipalities and municipal finances, are in dire straits.<sup>1</sup> Total state debt, not even counting local debt, is now in excess of \$5 trillion, which equates to roughly \$16,000 per capita.<sup>2</sup> The situation is even more dismal when corrections are made for faulty reporting. For example, the City of Detroit revealed roughly \$3.5 billion in previously undisclosed liabilities after reevaluating its pension obligations as part of its bankruptcy petition.<sup>3</sup> Besides Detroit, many other cities, states, and territories, such as Puerto Rico, are widely believed to be close to defaulting on their debt.<sup>4</sup>

In this Article, we argue that this financial calamity is attributable in part to the outdated and ineffective financial reporting regime for public entities and that fixing this regime is a necessary first step toward fiscal recovery. Ineffective reporting has obscured and continues to obscure the extent of the problem, thus delaying or even preventing corrective actions. Worse, ineffective reporting has created incentives for accounting gimmicks that have directly contributed to the dramatic decline of public sector finances. We provide concrete examples of advisable changes in accounting rules and advocate for institutional changes, particularly Securities and Exchange Commission (SEC) involvement that we hope will lead to better public accounting rules generally.

The current reporting regime is misleading and dangerous because of features that are not required by any particularity of public sector finances. The regime is misleading because it omits foreseeable long-term consequences from reported financial numbers. And it is dangerous because the omission of consequences blinds citizens and perhaps even politicians to the long-term

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1. See, e.g., Jeffrey Miron, *The Fiscal Health of U.S. States* 11–25 (Mercatus Ctr., Working Paper No. 11-33, 2011).
  2. Cory Eucalitto, *State Budget Solutions' Fourth Annual State Debt Report*, STATE BUDGET SOLUTIONS (Jan. 8, 2014), <http://www.statebudgetsolutions.org/publications/detail/state-budget-solutions-fourth-annual-state-debt-report>.
  3. See Mary Williams Walsh, *Detroit Gap Reveals Industry Dispute on Pension Math*, N.Y. TIMES (July 19, 2013, 9:01 PM), <http://dealbook.nytimes.com/2013/07/19/detroit-gap-reveals-industry-dispute-on-pension-math>.
  4. See Melvin Backman, *Is Puerto Rico Going to Default?*, CNN MONEY (July 2, 2014, 3:58 PM), <http://money.cnn.com/2014/07/02/investing/puerto-rico-downgrade>.

repercussions of politicians' choices.<sup>5</sup> At worst, it may prompt politicians to choose economically suboptimal measures precisely because it allows them to misrepresent their financial performance to voters.

The reporting regime we discuss about is separate from the budget. The budget is a plan of cash outlays and receipts, generally for one year. State constitutions and legislation require a budget and regulate its content and adoption.<sup>6</sup> In most cases, the budget requires a proposal by the executive and approval by the legislature.<sup>7</sup> This budget process tends to attract considerable attention by politicians and the press.<sup>8</sup> As it is only concerned with cash, however, the budget is quite uninformative about long-term fiscal health.<sup>9</sup> Assessment of long-term fiscal health requires information about other components of state wealth, in particular obligations and other non-cash assets. Such information appears in the financial reports that are the subject of this Article.

A simple observation about state finances and budget rules illustrates the preceding point. Almost all states require a balanced budget.<sup>10</sup> That is, they require that the projected inflows are at least equal to the projected outflows.<sup>11</sup> To the extent actual inflows and outflows diverge, many states impose constraints to rebalance the two.<sup>12</sup> And yet, states have amassed massive financial shortfalls over time.<sup>13</sup> This was possible because the budget and hence the balanced budget requirement only relates to cash movements in the

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5. In this paper, we take it for granted that improving disclosure would be beneficial. While there are contexts in which improving disclosure can be counterproductive (for example, diplomatic negotiations; see also Jacob E. Gersen & Matthew C. Stephenson, *Over-Accountability*, 6 J. LEGAL ANALYSIS (forthcoming 2014) (describing situations in which political accountability produces negative results)), there are no reasons to believe the present context is one of them. No commentator has claimed that withholding information about public finances from voters and politicians would be beneficial. And as we discuss below, there is empirical evidence that missing disclosure leads to negative consequences.

6. See NAT'L CONFERENCE OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS 2–6 (Oct. 2010) [hereinafter NCSL], *available at* <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>.

7. *Id.* at 3.

8. For example, a search on *wsj.com* revealed that there were 8 articles in the Wall Street Journal during 2014 concerning California's State Budget. See, e.g., Alejandro Lazo, *California Budget Increases Spending as State Enjoys a Surplus*, WALL ST. J. (Jan. 9, 2014, 2:46 PM), <http://www.wsj.com/articles/SB10001424052702303393804579310603091572462>.

9. A separate issue is that the budget as such is only a projection. Actual inflows and outflows may differ. See Thomas A. Garrett, *State Balanced-Budget and Debt Rules*, 33 ECON. SYNOPSES (2011).

10. See NCSL, *supra* note 6, at 1–13.

11. See *id.*

12. See *id.*

13. See Miron, *supra* note 1, at 11–25; Eucalitto, *supra* note 2.

states' so-called general fund. This has allowed states to "balance their budgets" by, for example, reducing the contribution to their state pension fund.<sup>14</sup> The consequence is that, *inter alia*, the gap between state pension obligations and state pension assets has grown.<sup>15</sup> It is as if one were to balance the inflows and outflows in a checking account by drawing on a credit card. The checking account would not reveal any trouble even while large debts amassed on the credit card.

The tool to capture the economic situation comprehensively is the consolidated financial report. It combines positions of all subdivisions, netting out internal movements that are a wash from the perspective of the entity as a whole.<sup>16</sup> The consolidated financial report is not limited to cash; it includes assets and obligations of all types.<sup>17</sup> The requisite valuation of long-term assets and obligations is not straightforward. Benefitting from centuries of experience, modern accounting employs the so-called accrual system to deal with long-term assets and obligations. The accrual system requires reporting at the time of the transaction or when the obligation is promised, even if no cash is exchanged.<sup>18</sup> The details are contained in extensive rules and principles, such as the Generally Accepted Accounting Principles (GAAP) promulgated by the U.S. Financial Accounting Standards Board (FASB) or the International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board (IASB).<sup>19</sup> Preparation of financial reports in accordance with such rules is standard for private sector firms around the world and is mandatory for the vast majority of large firms.<sup>20</sup>

Most U.S. states and local entities prepare financial reports in accordance with a separate set of GAAP developed by the Governmental Accounting Standards Board (GASB).<sup>21</sup> Superficially, public sector GAAP resembles its private sector counterpart. Like FASB, GASB is organized by the private Financial Accounting Foundation with the purpose of crafting principles to "[a]ssess the finances of the government in its entirety" using a

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14. NCSL, *supra* note 6, at 8.

15. James Naughton et al., *Economic Consequences of Public Pension Accounting Rules* (Sept. 5, 2014) (unpublished working paper), *available at* <http://ssrn.com/abstract=2199067>.

16. WARREN RUPPEL, *GAAP FOR GOVERNMENTS* 2014, at 158 (2014).

17. *Id.*

18. LAWRENCE REVSINE ET AL., *FINANCIAL REPORTING & ANALYSIS* 57 (5th ed. 2012).

19. *Id.* at 17–21.

20. *Id.*

21. The Governmental Accounting Standards Board (GASB) has responsibility for setting standards for state and local governments and governmental not-for-profit organizations.

modified accrual system.<sup>22</sup> Beneath the surface, however, GASB deviates considerably from FASB.<sup>23</sup> We argue that many of these deviations are misguided and have disastrous consequences for public sector finances.

Under current GASB GAAP, the budgeting process and financial reports for public entities are often described as unintelligible.<sup>24</sup> One reason for this is that the current regime does not provide the information necessary to understand why the cash-based performance reported on the budget differs from the accrual-based performance on the financial statements (a so-called “reconciliation”).<sup>25</sup> Another reason is that the accrual measures themselves are incomplete, as GASB deviates in some important respects from true accrual accounting.<sup>26</sup> Below, we discuss examples that illustrate these shortcomings in concrete settings.

Crucially, there is now strong empirical evidence that the reporting failures not only conceal, but partially cause, fiscal problems.<sup>27</sup> Much of this

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22. *Summary of Statement No. 34*, GOVERNMENTAL ACCOUNTING STANDARDS BD., <http://www.gasb.org/st/summary/gstsm34.html> (last visited Oct. 4, 2014).

23. *See infra* Part II.A.

24. In the annual report filed immediately prior to Jefferson County’s bankruptcy, which at that time was the largest in the United States, there was no indication in its financial statements that there was anything wrong. Consider the following: “What do I do with a CAFR [comprehensive annual financial report]?” asks Cameron Smith, who, as policy director for the Alabama Policy Institute, has spent a considerable amount of time sifting through the wreckage of the Jefferson County crash. Even if there was truly damning information contained in a CAFR, it would be hard to find, says Smith. He sees CAFRs as a potentially insidious exercise in ‘flood[ing] the market with data that no one knows what to do with.’” Jonathan Walters, *Are the Comprehensive Annual Financial Reports Useless?*, GOVERNING.COM (Sept. 2012), <http://www.governing.com/topics/finance/gov-are-annual-financial-reports-useless.html>.

25. This is so in spite of GASB Concept Statement No. 1, which states: “Financial reports are used primarily to compare actual financial results with the legally adopted budget; to assess financial condition and results of operations; to assist in determining compliance with finance-related laws, rules, and regulations; and to assist in evaluating efficiency and effectiveness.” GOVERNMENTAL ACCOUNTING STANDARDS BD., No. 037, CONCEPTS STATEMENT NO. 1 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD: OBJECTIVES OF FINANCIAL REPORTING, at i (1987).

26. *See infra* Part II.A.2. GASB Statement No. 34 was the first to accept the idea of accrual accounting. GOVERNMENTAL ACCOUNTING STANDARDS BD., No. 171-A, STATEMENT NO. 34 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD: BASIC FINANCIAL STATEMENTS—AND MANAGEMENT’S DISCUSSION AND ANALYSIS—FOR STATE AND LOCAL GOVERNMENTS (1999).

27. There is long tradition of research showing the relevance of accounting policies for real decisionmaking in the private sector. For example, when companies were required to report the cost of postretirement medical costs or stock options on the company’s financial statements, the use of these employee benefits dropped dramatically even though the economics were unchanged. This point is discussed in detail in Part II.B.

Most importantly, having information reported in earnings has often been found to generate a market response even when the information in earnings was previously available.

evidence relates to municipal pension obligations, which are notoriously understated.<sup>28</sup> As we explain below, an aberration in the GASB rules allows states to hide some of their pension obligations by choosing a risky investment policy for pension assets.<sup>29</sup> Naughton et al. show that states that understate employee benefit costs end up “overinvesting” in labor, which exacerbates fiscal weakness.<sup>30</sup> Similarly, Andonov et al. find that states take on additional investment risk relative to private and non-U.S. public entities not subject to GASB reporting.<sup>31</sup> This means that improving government accounting will not only clarify states’ existing financial problems but also help improve decision making. These changes will limit the likelihood of similar fiscal problems in the future.<sup>32</sup>

In most of our discussion, we will refer to FASB rules as examples of rules superior to GASB rules.<sup>33</sup> Since better rules are readily available, it is unclear why GASB has not adopted them. In a recent white paper, GASB

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For example, in a study of debt-equity swaps, Hand (1990) found that there was a market reaction to the difference in earnings that was attributable to the debt-equity swap even though the debt-equity swap was announced several months prior to earnings. A debt-equity swap occurs when a firm issues equity and retires debt. Doing so affects earnings because there is no longer an interest expense associated with the debt. See John R. M. Hand, *A Test of the Extended Functional Fixation Hypothesis*, 65 ACCT. REV. 740 (1990).

28. For more information on the public pension understatement, see Robert Novy-Marx & Josh Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 1211 (2011); Marcia Van Wagner & John Lombardi, *Adjusted Pension Liability Medians for US States*, MOODY’S INVESTORS SERV. 1 (June 27, 2013), <http://www.ncsl.org/documents/summit/summit2013/online-resources/Moody-Adjusted-Pension-Liability-Medians.pdf>.
29. See *infra* Part II.B.3.
30. The economic magnitude of this effect is dramatic. Naughton et al. document that the average state spends an extra \$125 million on hiring future employees due to the deviations of the GASB methodology from Financial Accounting Standards Board (FASB) measures of cost. Naughton et al., *supra* note 15, at 30. We place “overinvestment” in quotation marks because we generally remain agnostic as to whether the right response to an improved understanding of fiscal gaps would be to reduce spending or to raise taxes. That being said, the overall level of spending and taxing is not the only margin on which improper accounting may operate. Underrepresenting the cost of one input (say, state employees) will likely increase its use relative to another input whose cost is fully represented (say, purchases of goods).
31. Aleksandar Andonov et al., *Pension Fund Asset Allocation and Liability Discount Rates 29–30* (Social Science Electronic Publishing, Inc., Working Paper, 2014), *available at* <http://ssrn.com/abstract=2070054>.
32. We focus on the ultimate outcome and remain agnostic about the causal mechanism. Are politicians trying to fool voters or are the politicians themselves confused by bad numbers? We bracket this question because our proposal of improved accounting under Securities and Exchange Commission (SEC) guidance would seem to be an appropriate remedy under either interpretation.
33. We refer to FASB principles only as an example of a developed accrual accounting and disclosure system, and to illustrate the shortcomings of GASB. We do not mean to imply that FASB could be directly applied to governmental activities.



argued that its rules are required by particularities of the public sector.<sup>34</sup> As we discuss in detail, however, these arguments do not withstand scrutiny.

Given GASB's reticence in spite of evidence of mounting problems, we are skeptical that GASB will reform by itself. In fact, GASB is presently moving in the wrong direction, away from accruals toward more cash-based measures.<sup>35</sup> Some have speculated that this is due to incompetence or capture by the regulated public entities from where GASB's members hail.<sup>36</sup> We consider the problem too pressing to wait for the resolution of such debates. We point out that one important legal difference between GASB and FASB is that the former is not subject to SEC oversight like the latter.<sup>37</sup> This may explain the differences in substantive rules and suggests that the SEC could serve as a natural, qualified regulator to fix the current problem.

In fact, the only reason why the SEC has not been involved in public sector accounting is that the SEC interprets certain exemptions in the securities laws as a bar to such involvement.<sup>38</sup> Substantively, public sector accounting is squarely within the ambit of SEC expertise and responsibility in as far as the SEC is responsible for investor protection in the municipal bond market, which most public entities use for their financing.<sup>39</sup> Such protection

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34. GOVERNMENTAL ACCOUNTING STANDARDS BD., WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS—AND SHOULD BE—DIFFERENT 1 (revised Apr. 2013), available at [http://gasb.org/cs/ContentServer?c=Document\\_C&pagename=GASB%2FDocument\\_C%2FGASBDocumentPage&cid=1176162354189](http://gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176162354189).

35. Compare GOVERNMENTAL ACCOUNTING STANDARDS BD., No. 3-20, PRELIMINARY VIEWS ON CONCEPTS RELATED TO RECOGNITION OF ELEMENTS OF FINANCIAL STATEMENTS AND MEASUREMENT APPROACHES, at viii (2011) ("This document proposes a recognition framework for both the economic resources measurement focus and the near-term financial resources measurement focus."), with *id.* at 23 ("These minority members believe that the near-term measurement focus as proposed would further undermine the objective of providing information to assess inter-period equity . . .").

36. Consider the following quote from Arthur Levitt, Chairman of the United States Securities and Exchange Commission from 1993 to 2001:

While the Sarbanes-Oxley Act created an independent funding mechanism for the FASB, the GASB, in order to operate, still relies on donations from those for whom they write standards . . . Congress should also create an independent source of funding for the GASB, as it has for the FASB. The potential for crisis in municipal finance arguably is worse than that in corporate America; the public sector needs an equally independent and strong standard-setter.

Arthur Levitt, Jr., Opinion, *Standards Deviation*, WALL ST. J. (Mar. 9, 2007, 12:01 AM), <http://online.wsj.com/news/articles/SB117341014938031922>.

37. U.S. SEC. & EXCH. COMM'N, REPORT ON THE MUNICIPAL SECURITIES MARKET (2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

38. *Id.*

39. See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/whatwedo.shtml#>

is all the more important now that the municipal bond market has become riskier as a result of deteriorating public finances and the disappearance of monoline insurers, who used to insure investors against municipal default.<sup>40</sup> We therefore support the SEC's recent request to Congress for authority to regulate financial reporting of municipal bond issuers.<sup>41</sup>

In contrast to the SEC, this Article explicitly cautions that merely mandating compliance with existing GASB will not be sufficient. The GASB rules themselves must be improved to ameliorate the problems caused by insufficient financial reporting of public finances. Part I reviews the idea and practical relevance of consolidated financial reporting using accrual accounting. Part II highlights the shortcomings of the current GASB regime. It discusses several concrete examples of how GASB has tolerated and even caused unsound financial choices on behalf of the states. Part III refutes GASB's stated reasons for these deviations. GASB's reticence to enact reform leads Part IV to suggest that the SEC should be provided with additional rulemaking power to enact the necessary reforms.

## I. FUNDAMENTALS OF FINANCIAL REPORTING

This section outlines in greater detail how financial reporting works and what research has shown that it accomplishes from an economic standpoint. First, we introduce the core concept of accrual accounting. We illustrate accrual accounting's superiority to cash accounting at tracking long-term economic performance. Second, we explain that the most effective accrual accounting regime<sup>42</sup> generates financial statements that not only report

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.VG86oVXUuPg (last visited Nov. 21, 2014); U.S. SEC. & EXCH. COMM'N, *supra* note 37, at 71.

40. For a summary of the decline of monoline insurance, see Todd L. Ely, *No Guaranties: The Decline of Municipal Bond Insurance*, 32 PUB. BUDGETING & FIN. 105, 105–07 (2012). On state's use of the bond market to cover budget shortfalls, see Scott Pattison & Michael Streepy, *Municipal Bonds In 2011: An Update on State and Local Borrowing*, NASBO (Nov. 23, 2011), [http://www.nasbo.org/sites/default/files/Municipal%20Bonds%20-%20An%20Update%20on%20State%20and%20Local%20Borrowing\\_0.pdf](http://www.nasbo.org/sites/default/files/Municipal%20Bonds%20-%20An%20Update%20on%20State%20and%20Local%20Borrowing_0.pdf).

41. See U.S. SEC. & EXCH. COMM'N, *supra* note 37, at viii (requesting that Congress "[a]uthorize the Commission to establish the form and content of financial statements for municipal issuers who issue municipal securities, including the authority to recognize the standards of a designated private-sector body as generally accepted for purposes of the federal securities laws, and provide the Commission with attendant authority over such private-sector body"). The SEC report was preceded by GOV'T ACCOUNTABILITY OFFICE, GAO-11-267R, DODD-FRANK WALL STREET REFORM ACT: ROLE OF GOVERNMENTAL ACCOUNTING STANDARDS BOARD IN THE MUNICIPAL SECURITIES MARKETS AND ITS PAST FUNDING (2011), which was in turn mandated by section 976 of the Dodd-Frank Act.

42. Such as that employed by FASB for private entities.

financial information based on accruals but also reconciles that information to cash-basis accounting. Third, we review empirical evidence emphasizing the importance of effective reporting for spending. This evidence shows that an effective accounting regime provides transparency into past spending and provides the foundation to set policies that determine future spending. Finally, we conclude with some observations about realistic expectations of any financial reporting regime. We acknowledge that accrual accounting is not perfect and that financial economists often make ad hoc adjustments for aspects of accrual accounting when trying to understand the economic value of a reporting entity.<sup>43</sup> But many of these adjustments arise due to economic activities that are specific to the private sector.<sup>44</sup> Moreover, attempts to modify general accounting rules in this direction have been unsuccessful.<sup>45</sup>

## A. Accrual Accounting

### 1. Illustration of Cash Versus Accrual Accounting

The mechanics of accrual accounting are best illustrated through an example contrasting it with cash accounting. Consider a magazine publisher that sells a three-year subscription to a customer who pays the full three-year price of \$300 upfront. Further, assume that the costs of production and distribution are \$60 per customer per year, and that those costs are paid in cash each year. Under a cash-based approach, the publisher would record cash inflows of \$300 in the first year, and cash outflows of \$60 each year for three years. The publisher would have cash-basis income of \$240 in the first year, and a cash-basis loss—also known as a net outflow—of \$60 in each of the next two years. This is illustrated below.

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43. In particular, such examples explain why new economy firms, such as Twitter or Facebook, can raise billions in their initial public offerings even though their accounting statements misleadingly imply that the firms are essentially worthless. *See* IVO WELCH, CORPORATE FINANCE 182–85 (3d ed. 2014).

44. For example, research and development activity, which is discussed *infra* Part I.D.

45. For example, the Economic Value Added (EVA) approach, which is discussed *infra* Part I.D.

TABLE 1. Cash-Basis Income Determination

	Year 1	Year 2	Year 3	Total
Cash inflows	\$300	\$0	\$0	\$300
Cash outflows for production and distribution	(60)	(60)	(60)	(180)
Net income (loss)—cash basis	240	(60)	(60)	120

The cash-basis income reflects the flow of cash—similar to looking at a personal bank account. In contrast, and as we will show in this section, accrual accounting does not follow the flow of cash. Accrual accounting has in fact become the dominant form of accounting in large part because it overcomes the inherent mismatch between economic benefits and costs that arise due to timing differences in cash flows.<sup>46</sup> In the above example, the inflows of \$300 in the first year do not match with the outflows of \$60 in the current year as well as the following two years. The magazine that is produced and distributed in the first year at an economic cost of \$60 did not produce an economic benefit of \$300. To wit, an observer who had access to the cash accounting numbers only for Year 1 might be misled into thinking that the company has made an economic profit of \$240 in Year 1, rather than the \$40 it actually made. More to the point, the focus on cash inflows and outflows in any given year with no attention paid to *other* changes in the business paints an incomplete and hence a potentially grossly distorted picture of the underlying economic situation.<sup>47</sup>

By contrast, accrual accounting matches economic benefits—the subscription revenue—with economic costs—the price of magazine production and distribution.<sup>48</sup> As a result, it produces a measure of operating performance that provides a clearer picture of the success or failure of past economic transactions. This is illustrated below.

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46. REVSINE ET AL., *supra* note 18, at 57.

47. *Id.*

48. *Id.*

TABLE 2. Accrual-Basis Income Determination

	Year 1	Year 2	Year 3	Total
Revenue	100	100	100	300
Expenses for production and distribution	(60)	(60)	(60)	(180)
Net income (loss)—accrual basis	40	40	40	120

Accrual accounting shows revenue of \$100 each period, even though the \$300 is received in full at the start of the first period. This is because accrual accounting recognizes revenue when it is both earned and realizable.<sup>49</sup> Earned implies that the company has performed its obligations, which in this case means producing and shipping the magazine to the customer.<sup>50</sup> Realizable requires that the company reasonably expects payment.<sup>51</sup> In the above example, since the customer has paid the full three-year subscription upfront, the only contingency is whether the revenue is earned. Therefore, it is upon the shipment of each year's magazine that revenue is recognized.<sup>52</sup>

The annual expense of \$60 is recorded each year when the associated revenue is recognized and hence the expense is incurred, rather than when the expense is paid. Again, the primary advantage of accrual accounting is that it matches economic benefits with the corresponding economic costs. The recognition of expense is recorded using what is called the matching principle.<sup>53</sup> The matching principle requires that when a particular expense can be matched to a particular stream of revenue, both the expense and revenue be recognized at the same time.<sup>54</sup> In the above example, since \$100

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49. *Id.*

50. *Id.*

51. For example, if goods were shipped to a customer who was bankrupt and not expected to pay for the goods, the company would not be permitted to recognize the revenue associated with this transaction.

52. Under accrual accounting, the fact that the publisher was paid in advance creates a liability for Deferred Revenue equal to \$200. This liability is reduced in later periods when the magazine is actually provided to the customer and the revenue is recognized.

53. REVSINE ET AL., *supra* note 18, at 57.

54. If an expense cannot be matched to revenue, then it is recognized when it is incurred. This does not imply that payment has been made. Rather, it only implies that an obligation to pay has arisen. For example, the salary for a company's CEO is recorded in the period during which he has earned his salary. If the CEO's salary is \$100,000 for a twelve-month period, then the salary expense for the year is \$100,000. It could be the case that the CEO has not been paid the full \$100,000 due to payroll periods that end on different dates than the company's fiscal year. Any difference between what is paid and what was incurred gives rise

of revenue is recognized each period, the associated costs of distribution and production of \$60 are recognized each period. As was the case with revenue, the flow of cash is not part of the expense recognition criteria.<sup>55</sup>

The application of accrual accounting does not change the aggregate long-term financial statement impact of a specific transaction. Eventually, expenses and revenues will appear in accounting statements under both a cash and accrual basis.<sup>56</sup> In the above example, the publisher has an accumulated net income of \$120 under both approaches at the end of three years. Rather, an accrual system changes when aspects of a particular economic transaction are reflected in the financial statements, and it does so in a way that provides critical information.<sup>57</sup> Accrual accounting matches economic benefits with economic costs, thus providing a clearer picture of the economic benefit to the publisher of selling subscriptions.<sup>58</sup>

## 2. Cash Flow Projections Are Inferior to Accrual Accounting

Despite the fact that accrual accounting only changes when aspects of a particular transaction are recorded in financial statements, the benefits of accrual accounting are not supplanted by cash flow projections. In the above example, the underlying economics would have been clear if a three-year cash flow projection were made available. If the company had only one transaction, then a cash flow projection at the time that transaction is undertaken is just as informative as accrual accounting. But once numerous transactions are aggregated, cash flow projections can provide a very misleading picture of company performance.

Consider again a company that is always paid \$300 for a three-year subscription. But contrary to the earlier example, assume that the costs of production and distribution are now \$150 per customer per year rather than

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to either a prepaid item (if more than \$100,000 was paid) or an accrued item (if less than \$100,000 was paid).

55. Suppose that the expenses for production and distribution were paid upfront by the publisher. In this case, the recorded expense would still be \$60 each period and the reported income would be unchanged. The additional amounts paid in cash in the first year would be recorded as a Prepaid Expense, which is an asset. Similarly, if the expenses for production and distribution were paid at the end of the three-year period, the reported income would again be unchanged. The company would still record an expense of \$60 each period, and to the extent that it hasn't paid those expenses, it would also record an Accrued Expense, which is a liability. The existence of prepaid and accrued items is what gives rise to the name "accrual accounting."

56. REVSINE ET AL., *supra* note 18, at 60.

57. *Id.*

58. *Id.*

\$60. This means that every subscription sold generates an economic loss of \$50 per year (or \$150 over three years), as the revenue of \$100 is less than the costs of \$150. As a result, the accrual-basis loss will be \$50 each year. Since three years of subscription revenue are received in the first year, there will be cash-basis income of \$150 in the first year and a cash-basis loss of \$150 in the second and third years.<sup>59</sup>

Even though this company is undertaking an activity that generates a loss, it could remain “profitable” on a cash-basis for several periods if it continued to attract new customers. For example, consider the case in which the company sells to ten customers the first year, twenty-five customers the second year, and sixty customers the third year. In the first year, the cash inflow is \$3000 and the cash outflow is \$1500, resulting in positive cash flow of \$1500.<sup>60</sup> In the second year, the cash inflow is \$7500 and the cash outflow is \$5250, resulting in positive cash flow of \$2250.<sup>61</sup> In the third year, the cash inflow is \$18,000 and the cash outflow is \$14,250, resulting in positive cash flow of \$3750.<sup>62</sup> The cash-basis income is summarized below:

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59. The total cash inflow in the first year is \$300 and the total cash outflow is \$150, resulting in a net inflow of \$150 in the first year. In the second and third years, there is no cash inflow but there is a cash outflow of \$150, resulting in a net outflow of \$150 in each of these years.

60. The cash inflow of \$3000 is calculated by multiplying the subscription revenue per customer of \$300 by the number of new customers. There are ten new customers in the first year. The cash outflow of \$1500 is calculated by multiplying the cost of production and distribution per customer of \$150 by the total number of current customers. In the first year, there are a total of ten customers.

61. The cash inflow of \$7500 is calculated by multiplying the subscription revenue per customer of \$300 by the number of new customers. There are twenty-five new customers in the second year. The cash outflow of \$5250 is calculated by multiplying the cost of production and distribution per customer of \$150 by the total number of current customers. In the second year, there are a total of thirty-five customers, ten who subscribed in Year 1 and twenty-five who subscribed in Year 2.

62. The cash inflow of \$18,000 is calculated by multiplying the subscription revenue per customer of \$300 by the number of new customers. There are sixty new customers in the third year. The cash outflow of \$14,250 is calculated by multiplying the cost of production and distribution per customer of \$150 by the total number of current customers. In the third year, there are a total of ninety-five customers, ten who subscribed in Year 1, twenty-five who subscribed in Year 2 and sixty who subscribed in Year 3.

**TABLE 3. Cash-Basis Income Determination: Growing Company With Unprofitable Product**

	Year 1	Year 2	Year 3	Total
Cash inflows	3000	7500	18,000	28,500
Cash outflows for production and distribution	1500	5250	14,250	21,000
Net income (loss)—cash basis	1500	2250	3750	7500

The cash basis performance of the company is in stark contrast to the actual economic performance, which is a loss of \$50 per customer per year.<sup>63</sup> The accrual-basis income is summarized below:

**TABLE 4. Accrual-Basis Income Determination: Growing Company With Unprofitable Product**

	Year 1	Year 2	Year 3	Total
Revenue	1000	3500	9500	14,000
Expenses for production and distribution	1500	5250	14,250	21,000
Net income (loss)—accrual basis	(500)	(1750)	(4750)	(7000)

A comparison of the cash- and accrual-based performances provided above illustrates the problem of relying on cash-based accounting. The company in this example is not only profitable on a cash-basis in the first year, but it is increasingly profitable in each successive year. Conversely, when accruals are used the company is increasingly unprofitable. This illustration is consistent with economic reality since the company is selling a product that costs \$450 for only \$300 and is selling more of that product in later years. The difference between the two approaches arises because the receipt of cash for subscriptions is different from when the revenue associated with subscriptions is recognized.<sup>64</sup> The difference between accrual-based performance and cash-based

63. Fifty dollars is the difference between the revenue per customer per year of \$100, which is one-third of the three-year subscription cost, and the \$150 annual cost of production and distribution.

64. The cash-outflow and the expense for production and distribution are the same because those costs are incurred each period (due to the matching principle) and also paid each period.



performance is most significant for long term projects. In long term projects, the receipt of cash and the recognition of revenue can be far apart in time, and likewise for the payment of cash and the recording of an expense. As we discuss later, this is often true of public sector projects.<sup>65</sup>

## B. Reconciliation of Accruals and Cash Measures

While utilizing accruals are crucial, understanding the relationship between accruals and cash is generally considered one of the most critical inputs into performance evaluation. For this reason, the FASB,<sup>66</sup> the entity responsible for private sector standards, mandates the production of three distinct statements: the Income Statement, Balance Sheet, and Cash Flow Statement.<sup>67</sup> The Income Statement measures the “flows” over the course of the fiscal year.<sup>68</sup> Inflows are revenues and outflows are expenses.<sup>69</sup> Net Income is calculated by subtracting expenses from revenue.<sup>70</sup> The Balance Sheet provides a summary of the assets and liabilities of the company as of the last day of the fiscal year.<sup>71</sup> The Cash Flow Statement measures the “flows” of cash over the course of the fiscal year.<sup>72</sup>

It may at first seem surprising that an accrual accounting regime would provide a Cash Flow Statement. The Cash Flow Statement, however, is not simply a cash-basis equivalent to the income statement. Rather, it is designed to reconcile accrual accounting performance to the change in cash holdings

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65. The conclusion that accrual-based accounting is superior to cash-based accounting for calculating the economic value of a company extends beyond the example we have introduced. There is a significant body of research that compares valuation models that use accruals versus cash flows to estimate company value. This research generally finds that accruals outperform cash flows. See, e.g., Young K. Kwon, *Accrual Versus Cash-Basis Accounting Methods: An Agency-Theoretic Comparison*, 8 J. ACCT. & PUB. POL’Y 267 (1990); Stefan Reichelstein, *Providing Managerial Incentives: Cash Flows Versus Accrual Accounting*, 38.2 J. ACCT. RES. 243 (2000); Stephen H. Penman & Theodore Sougiannis, *A Comparison of Dividend, Cash Flow, and Earnings Approaches to Equity Valuation*, 15 CONTEMP. ACCT. RES. 343 (1998).

66. The FASB has responsibility for setting accounting and financial reporting standards for business enterprises and nongovernmental not-for-profit organizations.

67. FIN. ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS UPDATE NO. 2013-07, PRESENTATION OF FINANCIAL STATEMENTS (TOPIC 205): LIQUIDATION BASIS OF ACCOUNTING (2013).

68. REVSINE ET AL., *supra* note 18, at 69–74.

69. *Id.*

70. *Id.*

71. An asset is a resource under the control of the company that has measureable future economic benefits. Conversely, a liability is a claim that has arisen from a past transaction. The difference between total assets and total liabilities is referred to as shareholders’ equity.

72. REVSINE ET AL., *supra* note 18, at 208–10.

over an accounting period.<sup>73</sup> In other words, the Cash Flow Statement begins with Net Income, which is determined using accrual-basis accounting, and then makes adjustments for changes in the assets or liabilities of the company to arrive at the increase or decrease in cash over the period.<sup>74</sup> This allows a financial statement user to easily identify whether the firm is generating positive cash flow from its operations and whether this performance is sustainable.

Consider again the example of a publisher who sells a three-year subscription with upfront cash payment of \$300 and annual costs of \$60. To produce the Cash Flow Statement, we need to identify changes in either assets or liabilities and then adjust Net Income by those changes. In this example, the three-year advance payment creates two balance sheet items: an asset of \$300 representing the cash held in the publisher's bank account, and a liability representing the future obligation to produce and distribute the magazine. The Cash Flow Statement uses changes in non-cash items to get to the ending balance, which reflects the overall change in cash items. Therefore, the only adjustment to Net Income relates to the liability of \$300 reflecting the publisher's obligation to produce and distribute the magazine. This liability, which is referred to as Deferred Revenue,<sup>75</sup> is reduced over time as the publisher produces and distributes the magazine, thereby recognizing revenue.

Therefore, at the exact time that the advance payment is received, there is a liability of \$300. This amount is then reduced by \$100 each time a magazine is distributed to the customer. For example, since \$100 of revenue is recognized in the first year, the remaining \$200 that was received in cash but not recognized as revenue is recorded as Deferred Revenue at the end of the first year. Similarly, in the second year when an additional \$100 of revenue is recognized, the balance of the Deferred Revenue account is reduced from \$200 down to \$100. Therefore, Year 1's Net Income of \$40 is aggregated with changes in liabilities and assets, which is a \$200 increase in liabilities,<sup>76</sup> to reach Net Cash Flow of \$240. The Cash Flow Statement arrives at the same number found in our original Cash-Basis Income Determination, where there were cash inflows of \$300 and cash outflows of \$60 for Year 1. The required Cash Flow Statement for the magazine publisher under FASB would be as follows:

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73. *Id.* at 209.

74. *Id.* at 1029.

75. *Id.* at 59–60.

76. The initial \$300 liability reduced by \$100 for the first magazine in Year 1.

TABLE 5. Cash Flow Reconciliation

	Year 1	Year 2	Year 3	Total
Net income (loss)	40	40	40	120
Change in Deferred Revenue	200	(100)	(100)	0
Net Cash Flow	240	(60)	(60)	120

### C. Economic Consequences of Financial Reporting for Private Firms and Entities

An important assumption underlying our analysis is that accounting information will affect policy decisions. In Part III, we report on recent research on public spending that empirically validates this assumption. To further bolster our claim, however, we now briefly review the extensive research on accounting's influence on spending by private firms.

Consider the following example. There are two identical companies with identical accounting requirements located in different jurisdictions. Both companies provide identical pension benefits to their employees. The provision of this benefit and the cost of doing so are widely known. Now, suppose that the regulator in one jurisdiction decides that companies in his jurisdiction must include the cost of employee pensions as a reduction in financial statement income. Such a change has no effect on the economic cost to the firm of providing pension benefits. The only difference is a financial reporting requirement. As a result, one might think that this change will not affect firm behavior. Yet research shows that such a requirement does affect firm behavior.

Numerous empirical studies show that requiring the inclusion of pension costs in the company's financial statements will decrease the allocation of employee compensation related to pension benefits. For example, when SFAS 106<sup>77</sup> mandated the recognition of postemployment benefits for the first time, there was a significant decline in the number of companies that

77. See Christian Leuz & Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, 38 J. ACCT. RES. 91 (2000).

offered this benefit to its workforce.<sup>78</sup> Similarly, SFAS 123R<sup>79</sup> preceded a significant decline in the use of stock options,<sup>80</sup> and SFAS 158<sup>81</sup> preceded a decline in the number of companies that provided pension benefits.<sup>82</sup> In each case, the new accounting standard increased the costs that had to be recorded on the company's financial statements and led to a reduction in the provision of the affected benefit. These studies demonstrate that accounting has real economic consequences.<sup>83</sup>

Additional studies also suggest that a firm subject to increased disclosure requirements will experience positive capital market consequences. This occurs because improved disclosure reduces the information asymmetry between the company and its investors, which in turn reduces the company's cost of capital. For example, Leuz and Verrecchia (2000) find that German companies have smaller bid-ask spreads and higher trading volume when they voluntarily adopt more onerous disclosure requirements by switching from German GAAP to an international reporting regime.<sup>84</sup> More generally, Hail and Leuz (2006) find that companies in countries with more extensive disclosure requirements, stronger securities regulation, and stricter enforcement mechanisms have a significantly lower cost of capital.<sup>85</sup>

#### D. Good vs. Perfect Accounting

In advocating a movement to an accrual accounting system similar to FASB, we are not claiming that accrual accounting is perfect or that reasonable people could not disagree about details of the accrual accounting rules. In particular, with respect to expenditures of uncertain value, such as

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78. H. Fred Mittelstaedt, William D. Nichols & Philip R. Regier, *SFAS No. 106 and Benefit Reductions in Employer-Sponsored Retiree Health Care Plans*, 70 ACCT. REV. 535, 535–56 (1995).
  79. *Summary of Statement No. 123 (Revised 2004)*, FIN. ACCOUNTING STANDARDS BD., <http://www.fasb.org/summary/stsum123r.shtml> (last visited Aug. 20, 2014).
  80. Lawrence D. Brown & Yen-Jung Lee, *Changes in Option-Based Compensation Around the Issuance of SFAS 123R*, 38 J. BUS. FIN. & ACCT. 1053, 1053–95 (2011).
  81. *Summary of Statement No. 158*, FIN. ACCOUNTING STANDARDS BD., <http://www.fasb.org/summary/stsum158.shtml> (last visited Aug. 20, 2014).
  82. Cathy Beaudoin, Nandini Chandar & Edward M. Werner, *Are Potential Effects of SFAS 158 Associated With Firms' Decisions to Freeze Their Defined Benefit Pension Plans?*, 9 REV. ACCT. & FIN. 424 (2010).
  83. These studies do not try to examine whether the new accounting standards increased social welfare. They only show that companies respond to accounting requirements even though those requirements have no effect on the economics of the benefits that are being provided to employees.
  84. See Leuz & Verrecchia, *supra* note 77, at 121.
  85. Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Security Regulations Matter?*, 44 J. ACCT. RES. 485, 488 (2006).

R&D,<sup>86</sup> there is always a tradeoff between reliability—faithfully recording historical transactions—and relevance—recording information in a manner than conveys economic reality.<sup>87</sup> But we believe that accrual accounting is the most effective approach for financial reporting in general, especially for public entities.

There are multiple reasons why accrual accounting is preferable to cash accounting. First, cash accounting is not an effective alternative if the objective is to measure the economic condition of the reporting entity.<sup>88</sup> While cash accounting does not present several of the prominent difficulties of accrual accounting since its flows are easily measured, it also does not provide much information about the viability of the entity. Cash is almost meaningless for evaluating long-term performance. For example, we may observe that a person just received \$100, but if we do not know whether this was a lottery win or a loan at an exorbitant interest rate, then we do not know if the person's financial position has improved or deteriorated as a result of the payment, let alone by how much. Using accrual measures, we may not capture this improvement or deterioration completely, but at least it is captured. In other words, accrual measures may be imperfect, but they are certainly better than cash measures to represent the entity's long-term financial situation. Having a reporting regime that ensures the transparent reporting of cash and accrual accounting is vastly superior to the current GASB system.<sup>89</sup>

Moreover, the most frequent complaints about FASB accounting do not generally apply to public sector entities. Adjustments for deferred tax positions,<sup>90</sup>

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86. Research and Development (R&D) is comprised of investigative activities into the development of new products or procedures or into improvements in current products and procedures. The standard financial accounting practice for R&D costs in the United States is to expense these costs as incurred. REVSINE ET AL., *supra* note 18, at 565. On average, most companies spend only a small percentage of their revenue on R&D (usually under 5 percent). Pharmaceuticals and high-tech companies tend to spend quite a bit more.

87. REVSINE ET AL., *supra* note 18, at 565–66.

88. *Id.* at 59.

89. *But see* Peter A. Diamond & Peter R. Orszag, *Accrual Accounting for Social Security*, 41 HARV. J. ON LEGIS. 173, 182 (2004).

90. Deferred tax assets and liabilities arise because of differences in the tax accounting and financial accounting systems. A company calculates its tax expense based on its accounting income. The actual tax payment to the IRS, however, is based on the taxable income. The difference between the tax expense and the actual tax payment gives rise to either a deferred tax asset or a deferred tax liability. Public entities do not pay taxes, and therefore this adjustment simply does not apply.

inventory,<sup>91</sup> and lease arrangements either do not apply or only apply in a very limited way to the public sector.<sup>92</sup> Similarly, adjustments for expenditures that will generate uncertain future revenue, such as research and development (R&D) or advertising,<sup>93</sup> are unlikely to make much difference. Most public entities have budgets for such expenditures that are only a small percentage of overall spending, the expenditures are generally consistent year-to-year, and the uncertain revenue streams are often short term in nature.<sup>94</sup> Finally, it is worth noting that competing approaches to accruals, such as the Economic Value Added (EVA) approach advocated by the consulting firm Stern Stewart & Company,<sup>95</sup> have empirically performed worse than accruals at explaining future stock price performance.<sup>96</sup>

Rather than debating these points in the abstract, we prefer to illustrate what we consider to be the failings of the GASB financial reporting system with concrete examples. We believe that these examples will demonstrate the superiority of an accrual accounting approach.

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91. The First In, First Out (FIFO) method assumes the first items you purchased or produced are the first items you sold, consumed, or otherwise disposed of. Therefore, inventory is valued based on the most recent purchases. The Last In, First Out (LIFO) method assumes the items you have most recently purchased or produced are the first items you sold, consumed, or otherwise disposed of. Therefore, inventory is valued based on the first items that were purchased. This can result in inventory levels lower than the market value of inventory.
  92. RUPPEL, *supra* note 16.
  93. For example, the tourism budgets for all fifty states totaled \$405 million for the 2012 fiscal year, which reflects a very small percentage of overall government spending. Moreover, tourism advertisements are primarily designed to generate tourists right away. Therefore, any future revenue attributed to current year spending would be small and any adjustments across periods would essentially offset each other.
  94. *Cf.*, e.g., JOHN CHIANG, CAL. STATE CONTROLLER'S OFFICE, STATE OF CALIFORNIA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013 (2014) (making no mention of advertising or R&D); STATE OF MICHIGAN STATE BUDGET OFFICE, STATE OF MICHIGAN COMPREHENSIVE ANNUAL FINANCIAL REPORT: FISCAL YEAR ENDED SEPTEMBER 30, 2013 (2013) (also making no mention of advertising or R&D).
  95. See Justin Pettit, *EVA & Strategy*, STERN STEWART & CO. RES. 4-5 (Apr. 2000), [http://www.sternstewart.com.br/publicacoes/pdfs/EVA\\_and\\_strategy.pdf](http://www.sternstewart.com.br/publicacoes/pdfs/EVA_and_strategy.pdf).
  96. See, e.g., Gary C. Biddle, Robert M. Bowen & James S. Wallace, *Does EVA Beat Earnings? Evidence on Associations With Stock Returns and Firm Values*, 24 J. ACCT. & ECON., 301, 331-33 (1997). This study is noteworthy because the companies in the empirical test were actual users of the EVA model, and the data that the researchers were using was actually provided by Stern Stewart & Company, who developed EVA.

## II. GASB'S DEPARTURES FROM ESTABLISHED ACCOUNTING NORMS AND THEIR CONSEQUENCES

We now describe the shortcomings of GASB relative to the best possible reporting regime sketched above. We first explain the main failings of GASB in the abstract, before turning to concrete examples of suboptimal policy choices hidden and caused by these failings. Our goal is to justify our ultimate proposal of SEC oversight, rather than to provide detailed proposals for concrete accounting rule changes. We therefore focus most of our attention on the concrete examples, as these are easier to understand and evaluate than GASB's abstract shortcomings.

### A. Faulty Rules and Principles

GASB requires the production of two financial statements—the Statement of Net Assets and the Statement of Activities.<sup>97</sup> The Statement of Net Assets presents the financial position as of the last day of the fiscal year.<sup>98</sup> This statement is similar to a Balance Sheet prescribed by FASB, as it displays the total assets and liabilities of the state.<sup>99</sup> The Statement of Activities summarizes the “flows” during the fiscal year.<sup>100</sup> This statement is similar to the Income Statement prescribed by FASB, as it reports the overall difference between inflows and outflows.<sup>101</sup> While the GASB has some similarities to FASB, it has crucial shortcomings.

#### 1. Insufficient Separation and Linkage of Information

GASB lacks the equivalent of a Cash Flow Statement.<sup>102</sup> There is nothing in the current governmental regime that allows a user to reconcile the cash-based performance of the budget with the accrual-based performance of the financial statements.<sup>103</sup> This omission is inconsistent with an effective accounting regime. As the publisher example illustrated, understanding how the accrual-based measure reconciles to the cash-based measure is a critical component of any performance evaluation.

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97. RUPPEL, *supra* note 16, at 126.

98. *Id.* at 127–32.

99. *Id.* at 131–32.

100. *Id.* at 295.

101. *Id.* at 132–33.

102. *Id.* at 185.

103. *Id.* at 201–03.

While some aspects of the GASB regime provide information about an entity's financial viability using accrual based accounting, it is not possible to understand the performance of the general fund—the object of the budget—on an accrual basis. GASB 34 mandates a reconciliation of governmental funds to the changes in net assets,<sup>104</sup> which has some similarity to the indirect cash flow statement mandated by FASB.<sup>105</sup> But this reconciliation aggregates all governmental funds, such that the change in the general fund is impossible to determine.<sup>106</sup> In particular, the budget provides expenditure data by category—for example, healthcare or education—whereas the reconciliation typically focuses on types of expense—for example, pension or employment benefits.<sup>107</sup> This makes it virtually impossible to identify specific expenditures or revenues that differ on a cash versus an accrual basis.<sup>108</sup>

Similarly, the Statement of Activities does not separate expenses and revenues into recurring and non-recurring items.<sup>109</sup> In addition, items are often recorded in the Statement of Activities by function—for example, park district—rather than type—for example, employee wages.<sup>110</sup> Since non-recurring

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104. *Summary of Statement No. 34*, *supra* note 22, at 31.

105. RUPPEL, *supra* note 16, at 184–85 (noting that the reconciliation provides a means to comparing actual fund flows with the comprehensive annual report).

106. See, e.g., Elizabeth Lynam, Testimony Before the Select Committee on Budget and Tax Reform on Improving Transparency, Forecasting and Flexibility in New York State's Budgetary Process (Dec. 17, 2009), *available at* <http://www.nysenate.gov/files/pdfs/Lyman.pdf> (noting that current financial reporting “provides a cash-to-GAAP reconciliation that is virtually unintelligible” and that budget “prepared by the Division of the Budget should be accompanied by a detailed explanation of the differences [from accruals] so that postponed commitments and revenue shortfalls are easily identified”).

107. *Summary of Statement No. 34*, *supra* note 22, at 87.

108. For illustration, suppose that half of higher education spending is on salaries for professors and support staff at universities. Suppose that these individuals earn a pension benefit that is worth 20 percent of their pay. Therefore, 10 percent of the budget is for pension benefits, which for 2012 amounts to around \$1.1 billion. Now, suppose that California does not actually make this contribution. The benefits have still been earned, so on an accrual basis, the budget would have \$1.1 billion of pension benefits included. But on a cash basis there is no cost included since no contribution was actually made. Ideally, this deferral would show up explicitly on the reconciliation. There would be a positive adjustment for an amount owed (on an accrual basis) but not yet paid (in cash). But what actually shows up is the “net pension obligation,” which is the change in the excess of the pension liabilities over the pension assets, for all governmental units. This is not the same item. It is not possible to identify what portion of this amount is attributable to higher education, nor what amount is related to the specific accrual during 2012. Similarly, it is not clear whether this difference arose because earned benefits were not funded or there was some other actuarial gain or loss during the year—for example, poor investment performance.

109. RUPPEL, *supra* note 16, at 132–37.

110. See *Summary of Statement No. 34*, *supra* note 22, at 17 (stating that governmental activities should be presented by function and business-type activities by segment).



items—for instance, the sale of a state owned asset—can be bundled with the total revenues or expenses of a function, the identification of the performance of the state absent non-recurring items is not straightforward.<sup>111</sup>

Relatedly, GASB only requires financial statements for one year at a time, and does not require that financial statements for prior years be prepared using the same accounting methods as the financial statements for the current year.<sup>112</sup> This is in contrast with FASB, which requires that financial performance data always be provided for the last two or three years using the same accounting principles and methods from period to period.<sup>113</sup> This so-called consistency principle allows financial statement users to evaluate the progression of the private reporting entity's financial situation from year to year, unconfounded by changes in accounting practices.<sup>114</sup> The absence of this requirement in GASB allows public reporting entities to camouflage changes in their situation by changing their accounting choices.<sup>115</sup> These types of distortions are closely related to the deviation from true accrual accounting.

## 2. Incomplete Implementation of Accruals

By far the gravest shortcoming is GASB's incomplete implementation of accrual accounting. Under GASB, most routine transactions that mirror those found in the private sector—for example, running a parking garage—generally follow some accrual accounting principles.<sup>116</sup> There are a number of

111. RUPPEL, *supra* note 16, at 136–37.

112. See GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 62 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD 34 (2010) (stating that for changes in accounting principle prior period financial statements should be included as *previously* reported).

113. Information must be provided for the last two years of balance sheet and three years of income statement and cash flow statement.

114. REVSINE ET AL., *supra* note 18, at 76–83.

115. See, e.g., Eileen Norcross, *Fiscal Evasion in State Budgeting* 15–17 (Mercatus Ctr. Geo. Mason U., Working Paper No. 10-39, 2010). For example, a state can move up the due dates on merchant-collected sales taxes from early next year to late in the current year, thus allowing these taxes to be counted as revenues for the current year. See Michael Granof, *Stupid Budget Tricks*, N.Y. TIMES (Aug. 9, 2008), <http://www.nytimes.com/2008/08/09/opinion/09granof.html?pagewanted=print>. In an extreme case, this can result in doubling of recorded revenue. To illustrate, consider a case where all tax receipts of \$100 are due and received on January 1 (the first day of the fiscal year). If the due date is moved to December 31 (the last day of the fiscal year), then the revenue in the implementation year is \$200—the \$100 received on January 1 and the \$100 received on December 31. This doubling of revenue occurs even though actual tax receipts continue at \$100 per year.

116. OFFICE FIN. MGMT., *Generally Accepted Accounting Principles*, <http://www.ofm.wa.gov/policy/80.20.htm> (last visited Aug. 20, 2014).

important ways, however, in which GASB deviates from full accrual accounting. These deviations often resemble a cash-based rather than an accrual-based approach to financial statement recognition.<sup>117</sup> The examples we present in the following section are due to this shortcoming. As a result, the suboptimal decisions we describe will not be transparent even if the previous shortcomings were fixed.

The most prominent and numerically important example of incomplete accrual accounting is the GASB approach for pension obligations. This deviation from accrual accounting by itself has resulted in public sector financial reports that understate the cost of pensions by several trillion dollars. According to a recent Moody's report, the median U.S. state's unfunded pension liability as a fraction of annual state revenue is 45 percent.<sup>118</sup> For some states, the situation is far bleaker. For example, Illinois would need 241 percent of its annual revenue to plug its pension gap.<sup>119</sup> From the perspective of this Article, the key point is that these numbers are far worse than states' official financial reports would lead one to believe.<sup>120</sup>

Consider the following example. A newly hired forty-year-old worker earns an annuity benefit of \$1000 a year payable when he reaches age sixty-five as a result of completing his first year of employment. Under FASB rules, the company has to record an expense that reflects the cost of this retirement benefit, which is equal to the present value of an annuity of \$1000

117. For example, retiree medical benefits are typically recognized during retirement rather than as something that is earned during an employee's working career.

118. See Wagner & Lombardi, *supra* note 28, at 1.

119. See Wagner & Lombardi, *supra* note 28, at 2.

120. For example, Illinois' reported unfunded liability is roughly \$85 billion, which represents a funded ratio of about 50 percent. This does not include \$26 billion in bonds issued to fund the pension plan, see Amanda Griffin-Johnson, *Illinois' Pension Bonds*, ILL. POL'Y INSTITUTE TAX & BUDGET BRIEF 1 (Oct. 20, 2011), [http://ghost.illinoispolicy.org.php53-9.dfw1-1.websitetestlink.com/wp-content/files\\_mf/1378246591pensionbonds1020.pdf](http://ghost.illinoispolicy.org.php53-9.dfw1-1.websitetestlink.com/wp-content/files_mf/1378246591pensionbonds1020.pdf), but does reflect numerous gimmicks employed to understate the pension liability. See Mary Williams Walsh, *The Illusion of Pension Savings*, N.Y. TIMES, Sept. 17, 2010, at B1, available at [http://www.nytimes.com/2010/09/18/business/18pension.html?\\_r=3&ref=business&src=me&pagewanted=print](http://www.nytimes.com/2010/09/18/business/18pension.html?_r=3&ref=business&src=me&pagewanted=print). Similarly, the unfunded liability in the June 30, 2011, actuarial valuation report for the City of Detroit was roughly \$640 million, which represented a funded ratio of about 92 percent. CITY OF DETROIT PROPOSAL FOR CREDITORS 23, 31 (June 14, 2013), available at <http://s3.documentcloud.org/documents/713693/detroit-emergency-manager-kevyn-orr-report-to.pdf>. The City of Detroit Proposal for Creditors, dated June 14, 2013, states that "Aggressive Actuarial Assumptions" means that the \$640 million unfunded liability is "substantially understated" and that a more reasonable estimate is closer to \$3.5 billion. See *id.* For additional related discussion, see Cory Eucalitto, *The Real Size of Detroit's Pension Funding Gap*, ST. BUDGET SOLUTIONS (July 15, 2013), <http://www.statebudgetsolutions.org/publications/detail/the-real-size-of-detroits-pension-funding-gap>.

payable at age sixty-five. A typical fixed income discount rate is around 4 percent, so the present value of \$1000 a year for life starting in twenty-five years is about \$4500. This is the price the employer would have to pay a financial firm to assume the pension obligation at market rates. It is also the expense recorded under FASB.

In contrast, GASB would discount the future annuity benefit using a rate based on the expected investment return.<sup>121</sup> Suppose that the pension trust established to fund the pension promise is invested 50 percent in equity and 50 percent in fixed income, and that the expected returns for those asset classes are 10 percent and 4 percent, respectively. GASB would then discount the future annuity benefit at 7 percent,<sup>122</sup> which would result in a present value of about \$2000. This amount represents the expense that is ultimately recorded under GASB. Hence, in this example, the state was able to provide a benefit that is worth \$4500 but only record an expense of \$2000.<sup>123</sup>

To see why this is wrong, consider what would happen if the trust were to reallocate its investments into 100 percent equity. Then the expected return on the pension fund assets would be 10 percent. Under GASB, this would now be the appropriate discount rate for the pension obligation.<sup>124</sup> At a discount rate of 10 percent, the annuity benefit starting in twenty-five years would be worth less than \$1000. According to GASB, the government can change the value of the pension obligation by changing the investment of the pension assets. Clearly, this does not accurately reflect the state's pension obligation.<sup>125</sup>

121. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 25 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD 18–19 (1994).

122. Seven percent is the expected investment return on a portfolio that is 50 percent equity and 50 percent fixed income, where the expected return on equity is 10 percent and the expected return on fixed income is 4 percent. The specific calculation is:  $50\% \times 10\% + 50\% \times 4\%$ .

123. The reporting regime for postretirement welfare coverage is even more extreme. For example, Detroit did not report any such obligation prior to its bankruptcy filing as GASB does not require that postretirement welfare benefits be reported. Upon filing for bankruptcy, Detroit reported postretirement welfare obligations of \$5.7 billion. This is in direct contrast with FASB, which has required an accrual based measure of postretirement welfare costs since 1994. See *Summary of Statement No. 106*, FIN. ACCOUNTING STANDARDS BD., <http://www.fasb.org/summary/stsum106.shtml> (last visited Aug. 20, 2014).

124. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 67 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD 19–20 (2012).

125. Consider the following quote from Kent Smetters, professor of business economics and public policy at Wharton: “State and local pensions are not covered under any reasonable accounting standards. Their accounting makes Enron look pretty good.” *Public Sector Pensions: Their Accounting Makes Enron Look Good*, KAW (Sept. 26, 2012), <http://knowledge.wharton.upenn.edu/article/public-sector-pensions-their-accounting-makes-enron-look-good>.

## B. Examples of Obscured Policy Choices

We now highlight a series of suboptimal policy choices concealed and arguably triggered by the shortcomings of the current GASB regime. Our goal in this Part is not to provide an exhaustive list of all the transactions where the GASB financial reporting implementation reflects inaccurate accrual accounting. Rather, we focus on three specific transactions that occur frequently and that have profound negative economic consequences. We focus on inefficient asset sales, distorted pay incentives, and unreasonable risk-taking. We describe each type of transaction in more detail below and outline how the accounting and disclosure requirements for public entities conceal the use of these suboptimal policy choices.

### 1. Inefficient Asset Sales and Leases

“If a governor told you there were a way to spread pork, raise funds for infrastructure investment, promote jobs, avoid raising taxes, and put a dent in the trade deficit—all in one fell swoop—you might think he had a bridge to sell you. And you’d be right.”<sup>126</sup>

States can improve their reported financial condition on GASB statements through the sale or lease of assets such as highways and parks or by selling future revenue streams from activities such as lotteries, toll roads, or parking garages.<sup>127</sup> This is because these assets or the present value of the future streams of revenue that they generate are typically not reported on a current market value basis on the Statement of Net Assets.<sup>128</sup> Thus any sale or lease, even at a grossly inadequate price, can have a positive effect on the state’s financial condition, as if the state has generated no value through the sale or lease.<sup>129</sup>

Consider a recent transaction from 2006 where Indiana entered into a seventy-five-year lease for its main toll road with a group of foreign investors for \$3.85 billion.<sup>130</sup> If the value of the toll road and the associated toll receipts were reported on the financial statements on a current market basis, a fairly

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126. Daniel Gross, *Lost Highway*, SLATE, [http://www.slate.com/articles/business/moneybox/2006/03/lost\\_highway.html](http://www.slate.com/articles/business/moneybox/2006/03/lost_highway.html) (last visited Aug. 20, 2014).

127. RUPPEL, *supra* note 16.

128. *Id.*

129. *Id.*

130. TIM BERRY, OFFICE OF IND. AUDITOR OF STATE, STATE OF INDIANA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2007, at 11, 163–64 (2007).

priced transaction would have had little financial statement impact. The only consequence would have been that a cash item—namely, the \$3.85 billion—would replace a tangible asset of the same value on the statement of net assets. The replacement would not have an impact on the statement of activities. But because the value was not recorded in the GASB financial statements, Indiana was able to record the cash payments received as part of the sale as a financial windfall.<sup>131</sup> In essence, it was as if money materialized out of nowhere.<sup>132</sup>

One of the most troubling aspects of these types of transactions is the fact that the GASB financial windfall does not depend on receiving a fair price. Assume for the sake of argument that the Indiana toll road was worth \$10 billion (a number derived by discounting all expected future toll income to present value). At that value, the sale for \$3.85 billion was a massive economic loss of \$6.15 billion. And yet, the sale allowed Indiana to show a purported \$3.85 billion improvement of its financial situation. To be sure, Indiana's liquidity position improved as a result of the sale as it now has more liquid cash on hand. But in value terms, the sale was a loss. An effective accounting system should reflect this scenario.

The inability to reflect the economic loss is significant because it is likely that these asset sales generate economic losses, even though the GASB treatment is favorable. Asset sales can only occur when there is a perceived benefit to both parties. When a potential buyer offers more than the value that a state perceives, the buyer must think that they can generate more money from the asset by operating it more efficiently than the state or by

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131. In the Indiana case, the state recorded proceeds of \$3.618 billion related to the lease of the toll road in its 2007 Comprehensive Annual Financial Report. *See id.*

132. In principle, such a situation can also arise under FASB, if and to the extent that economically valuable assets (such as brand recognition or research results) are not recorded as such. FASB applies more stringent criteria, however, in determining whether there has indeed been a sale. In Indiana's case, FASB would most likely record an asset (for the cash received from outside investors) and a liability (for the obligation to transfer the future toll receipts to the outside investors), while leaving revenue unchanged. The reason for this accounting treatment is that the state still plays a role in the generation of the toll receipts (the future revenue).

GASB has now recognized this issue as well and partially addressed it through the issuance of GASB 48 in September 2006. GASB 48 provides criteria that determine whether a particular transaction involving pledged revenue is a "sale" or "collateralized borrowing," which in turn determines whether additional revenue can be recorded in the year of the transaction as was done in the Indiana example. GOVERNMENTAL ACCOUNTING STANDARDS BOARD, STATEMENT NO. 48 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD 2 (2006). This standard allows a state to record a transaction as a sale as long as it is not involved in the fundamental activity that generates the revenue. *Id.* at 5. FASB would likely have a stricter interpretation, under which involvement in the future revenue would need to be both estimable and de minimis to record the transaction as a sale.

increasing revenue. That begs the question of why the state could not do the same thing.<sup>133</sup> Several municipal entities that have recently entered bankruptcy under Chapter 9 had asset sales in earlier periods that eventually led to reduced revenue in later periods.<sup>134</sup> In some cases, the desire to sell assets is strongest in the period immediately before the bankruptcy filing.<sup>135</sup>

To grasp the problem in its entirety, one also needs to consider how government spending responds to the asset sale or lease. Even though the sale potentially damaged the state's financial health, it also inflated reported revenue. As a result, politicians may be tempted to commit to additional spending initiatives. Therefore, even though resources were essentially reshuffled, with some loss in the process, politicians may commit to a level of spending that will drive the need for similar future transactions.<sup>136</sup> We discuss GASB's effect on spending in the following section.

## 2. Distorted Spending

Distortions in GASB reporting mean that inaccurate information is being used to make decisions that have economic consequences. Governments rely on GASB accounting as a foundation for certain policy choices, such as how to compensate public sector workers and whether to hire additional workers. For example, in its centralized budgeting process, Massachusetts derives a fully burdened rate for employees<sup>137</sup> using

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133. Consider the following: "In 2008, for example, Chicago Mayor Richard Daley auctioned off the city's 36,000 parking meters to a private investment group that included Morgan Stanley, the Abu Dhabi Investment Authority and the German-based insurance giant Allianz. Daley did it to balance the budget. The deal may cost Chicago drivers at least \$11.6 billion over the next 75 years, 10 times what the system was sold for, according to Bloomberg News. Since the deal went through, Morgan Stanley has raised parking fees 42 percent. It now plans on stuffing more cars into fewer metered spaces by getting rid of marking lines, raising the number of metered slots and expanding the hours that require fees. City auditors dubbed the parking deal 'dubious' because the city's chief financial officer didn't calculate how much the system would be worth to the city over the long term." Michelle Conlin, *States and Cities Selling Public Assets to Cover Their Costs*, CNSNEWS.COM (May 13, 2011, 9:04 AM), <http://cnsnews.com/news/article/states-and-cities-selling-public-assets-cover-their-costs#sthash.43ck1oR2.dpuf>.

134. See, e.g., Brian Chappatta et al., *Detroit Peddles Its Municipal Assets to Avoid Record Bankruptcy*, BLOOMBERG (June 14, 2013, 9:00 PM), <http://www.bloomberg.com/news/2013-06-14/detroit-on-bankruptcy-s-brink-stops-paying-some-debts-orr-says.html>.

135. See, e.g., *id.*; Conlin, *supra* note 133.

136. Cf. Gregory Korte, *State of the States: What to Do With Their Surpluses*, USA TODAY (Jan. 29, 2014, 4:14 PM), <http://www.usatoday.com/story/news/politics/2014/01/29/state-of-the-state-addresses-2014/4944317> (discussing the recent return of budget surpluses for some states).

137. The fully burdened rate is the total cost of all benefits. For example, a fully burdened rate of 20 percent implies that the total cost of an employee with a \$50,000 salary is \$60,000, which is calculated by multiplying the employee salary by one plus the fully burdened rate.

information derived from GASB financial statements.<sup>138</sup> As a result, distortions in GASB reporting can result in policy choices that are based on inaccurate information. These distortions are particularly large for postemployment benefits, such as pensions and retiree healthcare.<sup>139</sup> This occurs because GASB develops pension costs using an estimate of the cash contribution requirement, rather than using the actual economic value of the provided benefits, as is done under FASB.<sup>140</sup> When postemployment benefits are understated, labor appears less expensive than it actually is. This can lead to an overinvestment in workers, relative to the resources the state has available.

Naughton et al. empirically confirm these fears.<sup>141</sup> They constructed twenty years of data for each of the fifty states.<sup>142</sup> For each state, they collected information on the reported GASB pension costs.<sup>143</sup> Then they calculated what the costs would have been if the states were required to use FASB.<sup>144</sup> They examined whether large deviations between the reported GASB and hypothetical FASB amounts lead to increased labor expenditures in future periods.<sup>145</sup> Their regressions results show a positive association between the current difference between the GASB and FASB costs and future employment costs, and they found that this association becomes stronger over time.<sup>146</sup> The increasing significance of the positive relationship is consistent with states hiring too many workers each and every period, such that total expenditures are substantially higher several years in the future.

The additional costs they documented are substantial. Their regressions indicate that a \$1000 per capita understatement due to the deviation of GASB from FASB accounting is associated with a per capita increase of \$11 in public employee payrolls in the next three to five years.<sup>147</sup> This has startling repercussions for states. During the sample period, the average understatement

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138. See Leslie A. Kirwan, *Fringe Benefits, Payroll Taxes and Indirect Costs (ANF 5)*, MASS.GOV, <http://www.mass.gov/anf/budget-taxes-and-procurement/admin-bulletins/fringe-benefits-payroll-taxes-and-indirect.html> (last visited Aug. 20, 2014) (“Department heads are responsible for budgeting these [fringe benefit] costs from the applicable funds.”). The fringe benefit cost for retirement plans for 2010 was 6.16 percent.

139. Naughton et al., *supra* note 15, at 12–13.

140. *Id.*

141. *Id.* at 22.

142. *Id.* at 23.

143. *Id.*

144. *Id.* at 13.

145. *Id.* at 33.

146. *Id.* at 29–33.

147. *Id.* at 30.

of pension liabilities due to GASB's deviation from FASB was about \$1978 per capita.<sup>148</sup> The average state has about 5.7 million citizens.<sup>149</sup> Thus, an average state spent an extra \$125 million on hiring employees due to the misleading GASB methodology.<sup>150</sup> While the states received the services of the additional state workers, these benefits were presumably not worth the cost since the states hired these workers only because their costs were understated. This finding is very important because it shows that the harm associated with ineffective accounting is not limited to the reporting of inaccurate obligations. Rather, it illustrates that reporting of inaccurate obligations leads to other choices that increase future costs. Therefore, it is not only the case that the current GASB regime poses distributional fairness issues, but also that it leads to policy choices that have the potential to exacerbate future fiscal problems.

In addition to understating the cost of hiring new workers, the current GASB regime also does not provide transparency into pension benefit improvements. Under GASB, the pension contribution is typically made up of two components: the contribution requirement associated with the benefits accrued during the year and the contribution requirement associated with previously unfunded benefits.<sup>151</sup> When a state provides a benefit improvement, this increases the actuarial contribution to the pension plan. From the outside, however, it is unclear whether the increased contribution is due to benefit improvements or to a deviation in an actuarial assumption—for example, if the pension assets earned less than their expected investment return.<sup>152</sup> This is in sharp contrast with FASB and the principles of accrual

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148. *Id.*

149. *Id.* at 26.

150. *See id.* at 30 (discussing the coefficients of 5.7 million average state population, multiplied by a per capita increase of \$11 in public employee payrolls, multiplied by a per capita liability understatement of \$1978, and divided by \$1000 per capita understatement equaling an extra \$125 million spent on hiring employees).

151. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 27 OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD 6 (1994) ("The [ARC] should include the employer's normal cost and a provision(s) for amortizing the total unfunded actuarial accrued liability.").

152. *Cf.* Mary Williams Walsh, *Detroit Spent Billions Extra on Pensions*, N.Y. TIMES (Sept. 25, 2013, 3:08 PM), <http://dealbook.nytimes.com/2013/09/25/undisclosed-payments-cost-detroit-pension-plan-billions> (quoting a managing director at the firm of Conway MacKenzie, Mr. Moore: "[h]undreds of millions of dollars of plan assets intended to support the city's traditional defined benefit pension arrangements were converted to provide a windfall to the annuity savings accounts of active employees outside of the defined benefit pension plan").



accounting, which require that any deviations from prior benefit formulas or any early retirement provisions be explicitly reported as a separate expense item.<sup>153</sup>

Municipal governments can rely on this lack of transparency to provide for generous extra payments to certain individuals without public awareness. For example, Detroit recently revealed that its system has provided considerable extra payments over the past fifteen years.<sup>154</sup> These payments only came to light because of the additional investigative audits done as part of its bankruptcy filing.<sup>155</sup> While there is no conclusive proof, it is possible that many other states and municipalities have undertaken similar activities.

### 3. Excessive Risk Taking

As explained above, the GASB cost of providing pension benefits is inversely related to the expected return on the pension plan's investments.<sup>156</sup> Investments present a tradeoff of risk and return.<sup>157</sup> For a higher expected return, an investor must accept higher risk, and vice versa.<sup>158</sup> Thus, states can reduce their reported pension obligations by increasing the risk on the pension fund investments.<sup>159</sup> State exploitation of this loophole is the best explanation for two worrisome empirical findings. First, public sector plans have higher equity exposures making them riskier than private sector plans.<sup>160</sup> More importantly, the equity allocations increase or are diverted to even

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153. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 87: EMPLOYERS' ACCOUNTING FOR PENSIONS ¶ 261, illus. 5 (1985) (Accounting for a Plan Curtailment When Termination Benefits Are Offered to Employees).

154. Consider the following excerpt: "Detroit's municipal pension fund made payments for decades to retirees, active workers and others above and beyond normal benefits, costing the struggling city billions of dollars and helping push it into bankruptcy, according to people who have reviewed the payments. The payments, which were not publicly disclosed, included bonuses to retirees, supplements to workers not yet retired and cash to the families of workers who died before becoming eligible to collect a pension, according to reports by an outside actuary and other people with knowledge of the matter." Walsh, *supra* note 152.

155. See Matthew Dolan, *Report Faults Detroit Pension Funds*, WALL ST. J. (Sept. 26, 2013), <http://www.wsj.com/articles/SB10001424052702303796404579099524149455810> (An investigative report commissioned by Kevyn Orr one month prior to the bankruptcy filing found that "the city's largest pension fund had questionable interest rates applied to annuities. Investigators also raised concerns about bonuses paid even when the funds lost value.").

156. Andonov et al., *supra* note 31, at 9.

157. ZVI BODIE, ALEX KANE, & ALAN MARCUS, INVESTMENTS 2 (9th ed. 2010).

158. *Id.* at 3.

159. *Id.*

160. *Id.* at 3–4.

riskier asset classes during periods of fiscal stress.<sup>161</sup> Second, Andonov et al. find that in a comparison of public pension plans around the world, only U.S. pension plans invest heavily in risky assets, with most in equity.<sup>162</sup> Private and foreign countries' pension plans are not subject to GASB's approach to valuing pension obligations.<sup>163</sup>

Besides encouraging excessive equity investment, the disconnect between the GASB cost of providing a pension benefit and the cost determined under an accrual basis has also led to states issuing what are called "Pension Obligation Bonds," or POBs.<sup>164</sup> States that issue POBs sell fixed income obligations with a coupon rate similar to the FASB rate.<sup>165</sup> States then invest the proceeds, which are deposited in the pension plan, primarily in equities.<sup>166</sup> The investment allows states to make its revenue look better because the *reported* cost of a pension benefit under GASB is based on an expected contribution, which is affected by the plan's funding.<sup>167</sup> The actual cost of the pension benefit does not depend on the funding. Instead, the pension cost under GASB is equal to the "normal cost" plus an amortization of the unfunded pension liability.<sup>168</sup> The normal cost is the present value of

161. See, e.g., Michael Corkery, *Public Pensions Increase Private-Equity Investments*, WALL ST. J. (Jan. 26, 2012), <http://online.wsj.com/article/SB10001424052970203806504577181272061850732.html>.

162. Andonov et al., *supra* note 31, at 18–19.

163. GASB, which stands for Governmental Accounting Standards Board, generates accounting standards solely for US state and local governments. GOVERNMENTAL ACCOUNTING STANDARDS BD., <http://www.gasb.org/> (last visited Nov. 21, 2014).

164. The bonds took on some notoriety this past summer when two California cities, Stockton and San Bernardino, went bankrupt. Generous pensions awkwardly propped up with ill-timed Pension Obligation Bonds (POBs) contributed to both debacles. See Mary Williams Walsh, *How Plan to Help City Pay Pensions Backfired*, N.Y. TIMES (Sept. 3, 2012), [http://www.nytimes.com/2012/09/04/business/how-a-plan-to-help-stockton-calif-pay-pensions-backfired.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2012/09/04/business/how-a-plan-to-help-stockton-calif-pay-pensions-backfired.html?pagewanted=all&_r=0).

165. This is true of highly rated sellers, since the FASB rate approximates the AA corporate bond rate. Because municipalities are prohibited from selling tax-exempt bonds and investing the money to make more money, the bonds are sold in the taxable market. As a result, there is no ability to issue at lower tax-exempt rates. An interactive chart showing the relationship between state borrowing costs and the AAA rate can be found at <http://online.wsj.com/news/articles/SB10001424052748704858404576134090495990356?mod=googlewsj>.

166. Pew Charitable Trusts & Laura and John Arnold Found., *State Public Pension Investments Shift Over Past 30 Years*, PEW CHARITABLE TRUSTS, June 2014, at 3, available at <http://www.pewtrusts.org/~media/Assets/2014/06/PensionInvestments06032014.pdf>.

167. ALICIA H. MUNNELL ET AL., PENSION OBLIGATION BONDS: FINANCIAL CRISIS EXPOSES RISKS 3 (2010) ("POBs offer issuers an actuarial arbitrage opportunity.").

168. The GASB established in Statements 25 and 27 the actuarial parameters and reporting requirements for pension valuations, including calculation of the actual required contribution. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT OF GOVERNMENTAL ACCOUNTING STANDARDS NO. 25: FINANCIAL REPORTING FOR DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTION PLANS 17

the plan benefits that were earned during the current plan year.<sup>169</sup> In contrast, under FASB, the cost is based almost entirely on the value of the benefits earned during the year—consistent with accrual accounting principles—and therefore the cost is not affected by funding the plan with borrowed money.<sup>170</sup>

Consider a pension plan that has an accrued pension liability<sup>171</sup> of \$100, pension assets of \$50, and a normal cost<sup>172</sup> of \$5. Assume that the amortization period is ten years, so that the amortization component is also \$5.<sup>173</sup> Consequently, the state that sponsors this plan would have to report a pension cost of \$10, which is the sum of the \$5 normal cost and \$5 amortization. If the state issued \$50 of POBs with a 4 percent coupon rate, the plan would be fully funded due to the additional \$50 from the bond issue. Consequently, the amortization amount would fall to zero. The state would have to make the coupon payment \$2—namely, 4 percent of \$50. Nevertheless, the net effect would be to reduce the state's reported expenses to \$7 (\$2 coupon plus \$5 normal cost) for an accounting gain of \$3. This accounting gain is an economic illusion, as the state has done nothing to reduce its economic costs.

The fact that it is possible to have an accounting gain from the issuance of POBs is especially troubling when you consider that POBs are the state equivalent to gambling. States that issue POBs incur an additional fixed obligation with a set payment schedule, but they invest the assets used to make these payments primarily in the stock market.<sup>174</sup> States that issue POBs assume that they will earn more on their risky investments than they will have to pay investors,<sup>175</sup> though some may not have a positive return at

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(1994); GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT OF GOVERNMENTAL ACCOUNTING STANDARDS NO. 27: ACCOUNTING FOR PENSIONS BY STATE AND LOCAL GOVERNMENTAL EMPLOYERS 6 (1994).

169. HOWARD WINKLEVOS, PENSION MATHEMATICS WITH NUMERICAL ILLUSTRATION 69–70 (1977).

170. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 87: EMPLOYERS' ACCOUNTING FOR PENSIONS ¶ 44A (1985), *amended by* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 158: EMPLOYERS' ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS (2006).

171. The pension liability is the present value of all accrued pension benefits as of the valuation date.

172. The normal cost is the present value of accrued pension benefits earned during the current year.

173. Determined by dividing the pension assets of \$50 by the amortization period of ten years.

174. *See* PEW CHARITABLE TRUSTS & LAURA AND JOHN ARNOLD FOUND., *supra* note 166.

175. *See, e.g.*, Press Release, The Office of State Treasurer, State of Conn., Nappier Announces Landmark Bond Sale 1 (Apr. 22, 2008), *available at* [http://www.ott.ct.gov/pressreleases/press2008/pr04222008\\_2.pdf](http://www.ott.ct.gov/pressreleases/press2008/pr04222008_2.pdf) (“We achieved a favorable borrowing cost of 5.88%, which is well below the 8.5% assumed long-term return on assets of the Teachers’ Retirement Fund.” (quoting Denise L. Nappier)).

all.<sup>176</sup> The transaction is no different than an individual borrowing money and investing in the stock market—called leveraged investing—and it is a high risk strategy that increases the state’s risk profile.<sup>177</sup>

In fact, POBs create exactly the type of leverage that politicians condemn when used by financial firms.<sup>178</sup> Moreover, the way in which it increases risk is especially problematic for states because of the cyclical nature of tax receipts.<sup>179</sup> When the economy is performing poorly, asset returns are typically lower, creating a loss for the state as the interest obligations on the POB are set at the time of issuance.<sup>180</sup> This is problematic because this tends to happen when tax receipts, the state’s primary source of revenue, are also at their lowest level. The recent bankruptcy petition for Stockton, California, was due in large part to the use of POBs, and Detroit’s bankruptcy filing followed a missed POB payment.<sup>181</sup>

### III. THERE ARE NO GOOD REASONS FOR GASB’S DEPARTURES

In the preceding Part, we illustrated several of the pernicious effects of GASB’s deviations from accrual accounting. The deviations invite harmful

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176. ALICIA H. MUNNELL ET AL., *supra* note 167, at 4. There are rare occasions when this has been true. But for most issuers, this has turned out to be false. This is because POBs are typically issued when states need money, which is generally a time when interest rates are high and, therefore, the odds of earning more in the stock market are less. For example, Oakland issued a \$417 million POB designed to buy the city a fifteen-year “holiday” from its police and fire pension contributions in 1997. In 2010, Oakland’s city auditor did a careful analysis of the 1997 POB and found that the amount still owed by the City is roughly \$250 million higher than the scenario where the POBs were not issued in 1997 and the same payments were instead made to the pension fund. See Jennifer Gollan, *California Agencies Gamble on Pension Bonds to Cover Debts—and Lose*, CTR. FOR INVESTIGATIVE REPORTING (Oct. 29, 2013), <http://cironline.org/reports/california-agencies-gamble-pension-bonds-cover-debts-%E2%80%93and-lose-5443>.

177. Thad Calabrese, *Public Pensions, Public Budgets, and the Risks of Pension Obligation Bonds*, in SOCIETY OF ACTUARIES, PUBLIC PENSION FINANCE SYMPOSIUM 9–11 (2009).

178. Consider the following quote, “It’s the dumbest idea I ever heard,” Jon Corzine told Bloomberg.com in 2008 when he was still governor of New Jersey. “It’s speculating the way I would have speculated in my bond position at Goldman Sachs.” Eric Schulzke, *Pension Obligation Bonds: Risky Gimmick or Smart Investment?*, GOVERNING STATES & LOCALITIES 1 (Jan. 2013), <http://www.governing.com/topics/public-workforce/pensions/gov-pension-obligation-bonds-risky-or-smart.html>.

179. See Eric Schulzke, *Pension Obligation Bonds: Risky Gimmick or Smart Investment?*, GOVERNING (Jan. 2013), <http://www.governing.com/topics/public-workforce/pensions/gov-pension-obligation-bonds-risky-or-smart.html>.

180. For example, S&P returns during the two most recent recessions were negative. *Policy Basics: Where Do Federal Tax Revenues Come From?*, CTR. ON BUDGET AND POLICY PRIORITIES (last updated Mar. 2014), [http://www.cbpp.org/files/PolicyBasics\\_WhereDoFederalTaxRevsComeFrom\\_08-20-12.pdf](http://www.cbpp.org/files/PolicyBasics_WhereDoFederalTaxRevsComeFrom_08-20-12.pdf). This coincided with reduced tax revenue and hence large deficits.

181. See Walsh, *supra* note 164.

accounting gimmicks and obscure true financial positions, spectacularly so in the case of state pensions. In this Part, we consider GASB's claims that governments are so different from private companies that the accounting method utilized by private entities simply would not work.<sup>182</sup> We contend that these arguments are weak at best. There are no compelling reasons to deviate from a complete accrual approach to government accounting, even though the implementation of government accounting may have to differ in some details.

The affirmative argument for our position is simple. As we discussed in Part I, accrual accounting has evolved over centuries as the best, though imperfect, method of representing the evolution of an entity's long-term financial position. By GASB's own admission, the long-term financial position is of even greater interest for governments than usually shorter-lived businesses.<sup>183</sup> Governments also require measures of cash use, in particular for budgeting purposes.<sup>184</sup> In an accrual accounting system, this is easily available in the form of the Cash Flow Statement. The Cash Flow Statement reconciles the change in cash with the net income so that the budget based on accrual measures can be compared directly and effectively with the cash budget.<sup>185</sup>

This Part addresses GASB's claims of why government accounting should be different. At least with respect to accrual accounting, each one of these claims are unconvincing for one or more of three broad classes of reasons. First, many claims argue for additional disclosures by governments, not different financial disclosures. Second, many claims insist that government accounting must take a long view, but this is an argument *for* accrual accounting and against cash-based measures. Third, the need for coordinating financial statements with cash-based state budgets is best met by providing pure cash

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182. GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 34.

183. *Cf.* GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 25 (following its Concepts Statement No. 1, believing that financial information should be useful for citizens to assess whether there is "interperiod equity"; that is, whether current year revenues are sufficient to pay for services provided in the current year, and whether future taxpayers will bear the cost burden for services provided earlier).

184. Budgets are based on cash. According to the Office of Management and Budget: "The budget system of the United States Government provides the means for the President and Congress to decide how much money to spend, what to spend it on, and how to raise the money they have decided to spend. Through the budget system, they determine the allocation of resources among the agencies of the Federal Government. The budget system focuses primarily on dollars, but it also allocates other resources, such as Federal employment." *The Budget System and Concepts*, OFFICE OF MGMT. & BUDGET, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2005/pdf/concepts.pdf> (last visited Nov. 21, 2014).

185. REVSINE ET AL., *supra* note 18.

measures in a statement of cash flows. By contrast, GASB's current approach of injecting cash-based elements into a modified accrual system delivers neither a clear picture of the state's cash position nor a clear picture of the state's long-term economic position.<sup>186</sup> By attempting to merge accruals and cash—two distinct measures—the GASB approach produces distorted financial results that incentivize suboptimal policy choices.

This Part focuses on GASB's arguments since GASB is by far the most prominent defender of its standards, and, to our knowledge, the only one to have mounted a principled defense. Other detractors of accrual accounting for public entities point to the implementation costs such as training personnel, which seems trivial relative to the massive fiscal consequences expositied above.<sup>187</sup> Governments around the world have increasingly adopted accrual accounting in recent decades, suggesting acceptance of the superiority of accrual accounting.<sup>188</sup>

#### A. Longevity

Arguably the most important distinction emphasized by GASB is longevity.<sup>189</sup> Unlike private companies, governments will not go out of business.<sup>190</sup> The GASB employs this distinction to assert that governmental

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186. Compare the minority statement:

These minority members believe that the near-term measurement focus as proposed would further undermine the objective of providing information to assess interperiod equity by its requirements relating to short-term borrowings, such as tax anticipation notes (TANs). Currently, short-term borrowings are accounted for as liabilities when the borrowed funds are received and as reductions in liabilities when they are repaid. Per the proposed measurement focus, however, they would be reported as inflows of resources, rather than liabilities, when the borrowed funds are received and as outflows of resources, rather than reductions of liabilities, when the borrowed funds are repaid. In other words, they would be accounted for similarly to taxes and other revenues when the borrowed cash is received and as operating costs when it is repaid. The government would thereby give the misleading impression that it has improved its economic position by incurring obligations intended to cover near-term cash shortages and worsened its economic position when it liquidates those obligations.

GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 35, at 23.

187. Andy Wynne, *Is the Move to Accrual Based Accounting a Real Priority for Public Sector Accounting?*, ACCA, Jan. 2004, at 9–10.

188. PWC, TOWARDS A NEW ERA IN GOVERNMENT ACCOUNTING AND REPORTING (2013), available at <http://www.pwc.com/gx/en/psrc/publications/government-accounting-and-reporting-pwc-global-ipsas-survey.jhtml>.

189. GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 34, at 5.

190. *Id.*

accounting must focus more on the allocation of resources over the long term.<sup>191</sup> This includes, in particular, intergenerational equity—the requirement that current generations do not offload costs onto future generations.<sup>192</sup>

The premise that governments should have a longer-term perspective is the most compelling argument *for* pure accrual accounting, rather than an argument for the current GASB approach. The accounting prescribed by FASB for private businesses relies on a going concern assumption, which requires that all transactions be recorded based on the assumption that the accounting entity will be in operation indefinitely.<sup>193</sup> As a result, every set of audited financial statements has a going concern opinion, in which the auditors specifically identify the entity and state whether that entity is expected to continue operating indefinitely.<sup>194</sup> Without a positive going concern opinion, the financial statements must be adjusted to reflect the true economic condition of the company.<sup>195</sup> GASB also has a going concern opinion.<sup>196</sup> But GASB only requires that financial statement preparers evaluate whether there is substantial doubt about the government's ability to continue as a going concern for twelve months beyond the financial statement date.<sup>197</sup> As a result, a going concern opinion that doubts the ability of a government to continue operation is rare. Even Detroit did not receive an unfavorable going concern opinion for the financial statements issued before its bankruptcy filing.<sup>198</sup>

Reflecting the long-run situation of the entity rather than its short-term cash position is precisely the goal of accrual accounting.<sup>199</sup> If public entities have a long-term perspective, then accrual accounting should be utilized. The current rules reward accounting gimmicks that boost short-term cash

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191. *Id.*

192. *Id.* at 18.

193. FIN. ACCOUNTING STANDARDS BD., *supra* note 67.

194. REVSINE ET AL., *supra* note 18.

195. For example, during the financial crisis, Ford did not receive a positive going concern opinion as the auditors could not certify that the business was not at substantial risk of liquidation. As a result, the company had to make adjustments to its deferred tax position so that future tax benefits could no longer be recognized on the financial statements. These adjustments were reversed one year later when Ford's financial outlook had improved.

196. RUPPEL, *supra* note 16, at 432.

197. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENTS OF GOVERNMENTAL ACCOUNTING STANDARDS NO. 56: CODIFICATION OF ACCOUNTING AND FINANCIAL REPORTING GUIDANCE CONTAINED IN THE AICPA STATEMENTS OF AUDITING STANDARDS 6 (2009).

198. *See* CITY OF DETROIT, MICH., COMPREHENSIVE ANNUAL FINANCIAL REPORT (2012) (making no mention of an unfavorable going concern).

199. REVSINE ET AL., *supra* note 18.

income at the expense of decreased future revenues or increased future liabilities.<sup>200</sup> Intergenerational equity would be better served by true accrual accounting, which would prevent public entities from deriving short-term benefits at the expense of future generations.

In addition, even though governments are long-lived, politicians do not have similar longevity. A politician with a short horizon—like a governor in his second and final term—would have little incentive to defer revenues into later periods when he will not be in office. Rather, he will have every incentive to maximize current revenues so that he can ensure that the initiatives he cares for are funded during his tenure. To the extent that politicians have shorter horizons than corporate executives, there is an even stronger case for having accrual accounting in the public sector.

Moving from high-level principles to practical applications, GASB draws on the longevity argument to justify a different approach to valuing certain assets, such as financial assets held in state pension funds. According to GASB, “[t]he longer term view of operations of government is consistent with focusing on trends in operations, rather than on short-term fluctuations, such as in the fair values of certain assets and liabilities.”<sup>201</sup> This approach would indeed be sensible if “trends” in asset prices could be identified *ex ante*, such that short-term fluctuations could be recognized and disregarded for accounting purposes. Decades of financial research have conclusively demonstrated, however, that it is generally not possible to extrapolate future trends in asset prices from past performance.<sup>202</sup> Asset prices fluctuate in the short term because the long term is uncertain. In efficient financial markets, the current asset price is the best predictor of the risk adjusted future price. If it were not, smart investors would either flock to or flee from the asset. GASB should follow FASB rules and report assets using a fair value approach not because the short term matters in itself, but because the current price is the best predictor of long term developments.<sup>203</sup>

A direct consequence of the GASB’s position on pension asset values is that public entities can pretend not to bear the risk of their portfolio choices. Riskier portfolios generally produce a higher expected return but do so by

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200. See Michael Granof, *Stupid Budget Tricks*, N.Y. TIMES (Aug. 9, 2008), <http://www.nytimes.com/2008/08/09/opinion/09granof.html?pagewanted=print>.

201. GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 34, at 8.

202. See, e.g., Eugene F. Fama, *Random Walks in Stock Market Prices*, 51 FIN. ANALYSTS J. 75, 77 (1995); Jeff Stibel, *Why We Can't Predict Financial Markets*, HARV. BUS. REV. BLOG (Jan. 22, 2009), <http://blogs.hbr.org/2009/01/why-we-cant-predict-financial>.

203. BODIE ET AL., *supra* note 157.



increasing the probability that returns are negative.<sup>204</sup> For example, an investment in the S&P500 Index can be expected to earn 8 percent a year.<sup>205</sup> However, the actual return over the past five years has ranged from -37 percent to +26 percent.<sup>206</sup> The GASB's position allows public entities to benefit from the higher expected return assumption, by reducing reported obligations, while allowing states to defer shortfalls that occur when investment returns do not meet expectations.<sup>207</sup> Delaying loss recognition is a risky gamble. Prudent long-term oriented accounting would record the current asset value, which is the best estimate of the long-term asset value.

## B. Organizational Purpose and Stakeholders

The GASB emphasizes that public entities have a broader mission, and concomitantly more and different stakeholders, than businesses.<sup>208</sup> While businesses focus on wealth creation for their investors, governments must provide various important services for its citizens with little or no regard to financial returns.<sup>209</sup> Moreover, unlike shareholders who can sell, citizens must move away to exit their government.<sup>210</sup> Accordingly, “[a] government’s financial reports should give creditors, legislative and oversight officials, citizens, and other stakeholders the information necessary to make assessments and decisions relevant to their interests in the government’s accomplishment of its objectives.”<sup>211</sup> By contrast, “[h]istorically, the primary

204. *Id.*

205. John Linder & Neil Rue, *Developing Expected Return and Risk Assumptions*, PENSION CONSULTING ALLIANCE (Mar. 2012), <http://www.pensionconsulting.com/Portals/0/UserReports/2012%20PCA%20Asset%20Class%20Assumptions%20Report%201.pdf>.

206. *S&P 500*, WIKIPEDIA, [http://en.wikipedia.org/wiki/S%26P\\_500](http://en.wikipedia.org/wiki/S%26P_500) (last visited Nov. 21, 2014).

207. For example, in 2009 the California Public Employees’ Retirement System (CalPERS) pension plan reported that the asset value used to determine pension costs (the “actuarial value of assets”) was more than \$8 billion less than the market value due to investment losses that were not required to be recognized under GASB. CALPERS, STATE & SCHOOLS ACTUARIAL VALUATION AS OF JUNE 30, 2009 (2009), *available at* <https://www.calpers.ca.gov/eip-docs/about/pubs/employer/2009-st-body.pdf>. The actuarial valuation report notes: “We are monitoring the funded status of the State plans and Schools pool using the market value of assets since this is a better measure of the plans’ ability to pay benefits.” *Id.* at 9.

208. GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 34, at 8.

209. *Id.* at 3–4; *see also* Wynne, *supra* note 187, at 9–11.

210. GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 34, at 6.

211. *Id.* at 4; *cf. id.* at 7 (“For governments, information necessary to make political and social decisions is as important in shaping accounting and financial reporting objectives as information necessary to make economic decisions. Reflecting the needs of the stakeholders of business enterprises, including equity investors, financial reporting of business enterprises predominantly focuses on financial performance—earnings and its components. For business enterprises, information for making economic decisions is most important in shaping accounting and financial reporting objectives.”).

focus of [business] reporting has been on earnings and its components, with little explicit focus on nonfinancial measures of performance.”<sup>212</sup>

The essence of the GASB’s position is a non sequitur. It may be true that governments have more stakeholders.<sup>213</sup> If so, governments may need to have *additional*, non-financial disclosures, provided suitable measures exist. By contrast, the existence of more stakeholders would not be an argument for *different* disclosures to the stakeholders that governments and private entities share, which is investors. Genuine financial reporting should thus be unaffected by this difference between governments and businesses.

In fact, the presence of other stakeholders makes financial reporting more important, not less. The importance of financial information is vital for creditors, which governments have just like businesses. Creditors use financial statements to assess the likelihood that their debt will be repaid. Additionally, financial information is just as important for other stakeholders.<sup>214</sup> Financial performance is an important aspect of overall performance.<sup>215</sup> It is impossible to assess the quality of governmental management of public services without considering their costs. For example, to understand the long run sustainability of current government services, including pensions, citizens must know their true cost.<sup>216</sup>

Finally, the difference between “for profit” businesses and governments with respect to their financial objectives is overstated. While governments do not have shareholders who would receive profits as cash payouts—also known as dividends—financially well-run governments can decrease taxes. A decrease in taxes is the functional equivalent to a dividend payout from a citizen’s financial point of view. For example, imagine a citizen who owns one share of a for-profit business and also pays property taxes to her local government. If the business improves its performance such that it can pay an additional dollar in dividends, the citizen is one dollar richer. Equivalently, if the government improves its performance such that it can reduce taxes by one dollar, the citizen is also one dollar richer. As far as finances are concerned, an extra dollar earned or saved by the government and passed on through tax reductions is as useful as an extra dollar earned or saved by the business and passed on through dividends.

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212. *Id.* at 4.

213. We do not here take a position on whether a business corporation exists only for the benefit of shareholders or of other stakeholders as well.

214. REVSINE ET AL., *supra* note 18.

215. RUPPEL, *supra* note 16, at vii.

216. This attribute is evident in the current scrutiny placed on public sector pensions, whose costs will ultimately be borne by future generations.

### C. Sources of Revenue

GASB next draws attention to differences in the source of revenue. Unlike businesses, governments finance themselves primarily through tax revenue.<sup>217</sup> This is a one-sided transaction as opposed to an exchange, as in a sale of goods.<sup>218</sup> This difference is important from a technical accounting perspective. But differences in revenue sources cannot credibly be used to suggest that accrual accounting will not work for public entities. Under FASB, there are numerous sources of revenue besides the sale or exchange of goods and services, and there are also rules to handle one-time asset sales and non-exchange transactions, such as gifts.<sup>219</sup> Indeed, the recognition of taxes in the period for which they are levied, which is cited by GASB as an example of government accounting differences, mirrors several elements of the revenue recognition rules for non-exchange transactions under FASB.<sup>220</sup> While tax financing may require technical adaptations since business accounting rules do not consider tax revenue, it does not require deviations from the principles of accrual accounting.

### D. Role of the Budget

Finally, GASB emphasizes the importance of the budget.<sup>221</sup> The publicly disclosed and debated budget is an important tool of accountability for governments.<sup>222</sup> Conversely, budgets of businesses are generally not disclosed to outside investors or other stakeholders.<sup>223</sup> Governmental financial statements must provide sound information for budget planning and for assessing whether actual spending complied with the budgetary provisions.<sup>224</sup> For this reason, governmental financial statements should be of high quality and represent the government's financial position and performance as best as possible. The best known method for presenting financial performance is accrual accounting. To the extent that existing budget rules focus on cash measures, such measures must be reconciled to an accrual-based approach to provide transparency and accountability.

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217. RUPPEL, *supra* note 16, at 21.

218. GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 34, at 4.

219. REVSINE ET AL., *supra* note 18.

220. *Cf. id.* at 4.

221. GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 34, at 6.

222. *Id.*

223. *Id.* at 6.

224. *Id.* at 21.

In fact, the current conflation of accrual and cash measures under modified accrual accounting undermines rather than supports sound budget policy. For example, balanced budget requirements do not ensure the absence of long-term deficits if the budget is balanced only with respect to cash outflows and inflows in the current period. Financial reporting should reveal this through a principled use of accrual measures. By contrast, by utilizing unsuitable financial measurements, balanced budget requirements create merely the appearance of balanced budgets. Balanced budget requirements have fooled even informed observers into believing that states are not running a deficit, despite the fact that states have amassed massive deficits in their pension plans and elsewhere.<sup>225</sup>

#### IV. THE CASE FOR EMPOWERING THE SEC TO INTERVENE

The GASB's rules and principles should be changed to address the issues we identified in Part II. There is good empirical evidence to suggest such improved reporting will not only clarify but, in the long run, ameliorate public sector finances.<sup>226</sup>

Financial reporting is too complicated, however, for us to spell out all the details in this Article. In fact, the complexity and updating needs of financial reporting rules are so great that their development and maintenance has been entrusted to specialized bodies all over the world.<sup>227</sup> Accordingly, our focus here is on highlighting institutional reform that we hope will ultimately lead to better accounting standards for public entities. Concretely, we support the SEC's request to Congress for lifting some of the exemptions that currently prevent the SEC from applying the same beneficial influence it exerts on private accounting (FASB) to public accounting (GASB).

We will begin this Part by stating the case for SEC intervention in the GASB. Subpart IV.B discusses the SEC's current lack of authority to intervene

225. Cf. David A. Super, *Federal-State Budgetary Interactions*, in FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY 366, 371 (Elizabeth Garrett et al. eds., 2008) (asserting that "[s]tate requirements for annual balance mute concerns about intergenerational equity").

226. See discussion *infra* Parts I.C and II.B.2.

227. See, e.g., *IAS/IFRS Standards and Interpretations*, EUROPEAN COMM'N (Mar. 10, 2014), [http://ec.europa.eu/internal\\_market/accounting/ias/index\\_en.htm](http://ec.europa.eu/internal_market/accounting/ias/index_en.htm); Comm. Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221, Exchange Act Release No. 47,743, Investment Company Act Release No. 26,028, 80 SEC Docket 139 (Apr. 25, 2003), available at <https://www.sec.gov/rules/policy/33-8221.htm> (reaffirming FASB and its Generally Accepted Accounting Principles (GAAP) as the required accounting standards for registered issuers).

and implement such rules and regulations. As we explain in Subpart IV.C, however, this lack of authority is an anomaly, in that the basic philosophy of securities laws would cover the protection of investors in municipal securities and private issuers equally well. Subpart IV.D explains that there are no constitutional hurdles specifically with respect to the states, nor are there other concerns about legitimacy of federal action. Therefore, we support the SEC's request for regulatory authority from Congress.

This Article proposes a reform of only municipal financial reporting and, more specifically, of the institutions that develop the rules and principles for such reporting. We do not advocate a reform of the budget rules. This would require action by states, as budget rules are contained in state laws and constitutions.<sup>228</sup> Moreover, such change would be complicated since budget numbers are more than mere information for politicians and citizens. Various other budget rules, in particular balanced budget requirements, reference budget numbers. Changing these numbers would thus have effects beyond disclosure, and some of those effects might not be desirable.

#### A. Need for Regulatory Intervention

In principle, GASB could reform by itself. Moreover, states and municipalities are free to produce better reports on their own volition, as GASB compliance is not mandatory.<sup>229</sup> Unilateral action by individual states is unlikely, however.<sup>230</sup> After all, politicians in power benefit from the current system's ability to hide the true costs of their actions and delay painful measures until their successors are elected.<sup>231</sup> In theory, politicians' desire to reveal the true cost of their predecessors' reign might counterbalance their

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228. See NAT'L CONFERENCE OF STATE LEGISLATURES, *supra* note 6.

229. Cf. U.S. SEC. & EXCH. COMM'N STAFF WHITE PAPER TO CONGRESS, *Disclosure and Accounting Practices in the Municipal Securities Market*, at 7–8 (July 26, 2007) [hereinafter Staff White Paper], available at <http://www.sec.gov/news/press/2007/2007-148wp.pdf> (discussing how states use non-GASB methods).

230. Stiglitz highlights the tension underlying a government's incentives to be transparent, arguing that “[d]emocratic societies have a strong presumption in favor of transparency and openness in government. But there has also long been recognition that on their own, governments and their leaders do not have the incentives to disclose, let alone disseminate, information that is contrary to their interests.” Joseph Stiglitz, *Transparency in Government in THE RIGHT TO TELL: THE ROLE OF MASS MEDIA IN ECONOMIC DEVELOPMENT* 27, 29 (2002).

231. Ian Ball & Gary Pflugrath, *Government Accounting: Making Enron Look Good*, 13 WORLD ECON. J. 1, 1 (Jan.–Mar. 2012); cf. U.S. SEC. & EXCH. COMM'N, *supra* note 229, at n.33 (showing that states even deviate from the already loose GASB rules to avoid recognizing future costs).

own benefits from obfuscation. A look around the world suggests, however, that this counterweight is not sufficient in practice. Some newly elected governments have restated their predecessors' accounts to heave blame on them, most famously in Greece in 2004.<sup>232</sup> As the example of alternating French governments restating their respective predecessor's accounts demonstrates, however, such restatements are hardly a panacea.<sup>233</sup> The French example illustrates the simple truth that if accounting rules are bad, accounting numbers are not reliable.

Since the GASB has not reformed or implemented the sort of rules we advocate, SEC intervention is necessary.<sup>234</sup> To explain the lack of reform some have speculated that the GASB has been captured by state governments through personnel and other influence.<sup>235</sup> Alternatively, the GASB might be independent but hesitant to act because it understands that states' compliance with GASB rules is not legally mandatory and might break down if it becomes too politically costly.<sup>236</sup> In either case, the SEC should intervene and work with the GASB to move to a pure accrual system for issuers of municipal debt, and require compliance with these rules from municipal issuers. States and municipalities would remain free not to comply with these rules, but only if they were to withdraw from the bond market. We suspect that few states would do so.<sup>237</sup>

## B. Current Lack of Statutory Basis

At present, the SEC has no leverage over municipal accounting, even through the bond market. Municipal bonds are exempted securities under

232. See Vincent Koen & Paul van den Noord, *Fiscal Gimmickry in Europe: One-Off Measures and Creative Accounting* 6 n.2 (Econs. Dep't Working Papers, No. 417, 2005).

233. Cf. *id.* (mentioning that new French governments audited their predecessors in 1997 and 2002 and that the 1997 government was a left government succeeding the right, and inversely in 2002).

234. In its Preliminary Views report, which is expected to lead to an updated Statement of Governmental Accounting Concepts, the Board recommends that "the existing method of preparing financial statements using the current financial resources measurement focus should be replaced with the near-term financial resources measurement focus, which recognizes balances from a near-term perspective and flows of financial resources for the reporting period." GOVERNMENTAL ACCOUNTING STANDARDS BD., *supra* note 35, at 5.

235. E.g., Arthur Levitt, Jr., *Standards Deviation*, WALL ST. J. (Mar. 9, 2007), <http://online.wsj.com/news/articles/SB117341014938031922>.

236. It is also possible that GASB is a victim of insufficient institutional support. The FASB has an annual budget of \$39 million compared with \$8 million for the GASB. Similarly, the seven-member board of the FASB is employed full-time, whereas the seven-member GASB board is only employed part-time.

237. Currently, all of them borrow on the bond market. See MUN. SEC. RULEMAKING BD., 2013 FACTBOOK 77 tbl. (2014) (showing every state as having trades on the municipal market).

the securities laws.<sup>238</sup> As such, they are not subject to most of the rules of the securities acts.<sup>239</sup> In particular, they are not subject to the registration and reporting requirements of the acts and the SEC's authority to prescribe the form of financial reporting.<sup>240</sup>

A more aggressive reading of the securities acts might find authority for the SEC to intervene in section 15 of the Exchange Act.<sup>241</sup> It addresses fraud by dealers and is the statutory basis of Rule 15c2-12.<sup>242</sup> Rule 15c2-12 prohibits underwriters from underwriting municipal bond issues unless they have received a commitment from the issuer to provide regular financial information to the Municipal Securities Rulemaking Board.<sup>243</sup> By targeting the dealers and post-issue disclosure, the SEC was able to circumvent section 15B(d)(1) of the Exchange Act.<sup>244</sup> This so-called "Tower Amendment" merely prohibits the SEC from requiring an issuer "directly or indirectly *through a purchaser . . . of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any . . . document in connection with the . . . sale.*"<sup>245</sup> To improve the content of the financial information provided, the Commission could now argue that financial statements not based on high-quality accrual accounting are "deceptive."<sup>246</sup>

The SEC's official position, however, is that "the Commission generally lacks authority to prescribe the accounting standards that municipal issuers must use."<sup>247</sup> In its 2012 report on the municipal bond market, the SEC called for additional statutory authority to demand financial statements and prescribe their form or to regulate those who would prescribe their form.<sup>248</sup> We thus turn to the possibility of an intervention by Congress.

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238. Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(12)(A)(ii)–(B)(ii), (15), (17)(A) (2012); Securities Exchange Act of 1933, 15 U.S.C. § 77b (2012).

239. ROBERT R. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE §§ 6.3.1, 6.4 (1992).

240. Securities Exchange Act of 1934, 15 U.S.C. § 78c (12)(a), (13)(a) (2012).

241. Securities Exchange Act of 1934, 15 U.S.C. § 78o (2012).

242. See Municipal Securities Disclosure, Exchange Act Release No. 34-33742, 56 SEC Docket 5 (Mar. 17, 1994).

243. See 17 C.F.R. § 240.15c2-12(a), (b)(5)(i)(A).

244. Cf. AMDURSKY & GILLETTE, *supra* note 239, at 378 (commenting that "the Rule seems to achieve indirectly what the Tower Amendment appears to preclude the SEC from doing directly").

245. Securities Exchange Act of 1934, 15 U.S.C. § 78o-4(d)(1) (2012) (emphasis added).

246. Cf. 15 U.S.C. § 78o(c)(2)(B), (D) (2012) (prohibiting certain "fraudulent, deceptive, or manipulative" behavior and granting the SEC authority to craft measures "reasonably designed to prevent" such behavior).

247. U.S. SEC. & EXCH. COMM'N, *supra* note 38, at 71.

248. *Id.* at viii.

### C. Legitimacy of Congressional Intervention on Behalf of Investors

Congress should intervene in the name of investor protection. It is anomalous that the securities laws do not currently cover the municipal debt market with equal intensity as the private debt market. Congress need not invoke benefits to state and municipal politics to justify intervention.

The municipal bond market is of considerable size. It is one quarter of the size of the private bond market, with \$3.7 trillion in outstanding principal in 2012.<sup>249</sup> In the past, the municipal market was simpler for investors than the corporate market, as most municipal bonds were insured against default by credit insurers.<sup>250</sup> Since the financial crisis, however, these insurers have largely withdrawn from the market.<sup>251</sup> Today most municipal bonds are uninsured and therefore subject to default risk.<sup>252</sup> Given the size of the municipal market and its complexity, it is hard to see why investors would not need similar high quality disclosure for municipal bonds as they receive for corporate bonds.<sup>253</sup> Indeed, the SEC has already become more stringent in its prosecution of fraud to protect investors in municipal bonds. It has brought various enforcement actions against states and cities that mislead investors and, in many cases, later defaulted.<sup>254</sup>

One might argue that mandatory disclosure by large issuers is unnecessary. Disclosure will either be triggered by market pressure, so the argument would go, or it must be irrelevant (perhaps because investors can easily gather the information from other sources).<sup>255</sup> This argument is in tension with the rationale of the securities laws, however, as it would also obviate the need for mandatory private issuer disclosure.<sup>256</sup> Moreover, there is good reason to doubt the analytical validity of the argument. Disclosure by multiple issuers creates network externalities, such that individual issuers and

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249. U.S. SEC. & EXCH. COMM'N, *supra* note 242, at 5.

250. *See* Ely, *supra* note 40, at 109.

251. *See id.* at 108.

252. *Id.*

253. *Cf.* Letter from Mary Colby, Industry Practices & Procedures Chair, NFMA, to Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n (Oct. 6, 2010), *available at* [http://www.sec.gov/comments/ 4-610/4610-9.pdf](http://www.sec.gov/comments/4-610/4610-9.pdf).

254. Steve Malanga, *The Many Ways That Cities Cook Their Bond Books*, WALL ST. J., June 1, 2013, at A11.

255. *Cf., e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 286–90 (1991) (discussing how mandatory disclosure may be irrelevant because even in its absence market pressures would force firms to provide, and incentivize market participants to gather, information).

256. *Cf., e.g., id.* at 296 (noting that mandatory disclosure must be predicated on a failure of the aforementioned mechanisms for information provision).



investors might not be able to obtain optimal disclosure by themselves.<sup>257</sup> As reported in Part I.C, empirical research has documented that valuations and market quality improved after tightening of corporate disclosure requirements.<sup>258</sup>

#### D. Constitutionality

Congress has the constitutional authority to extend the securities acts' disclosure rules to municipal bond issuers.<sup>259</sup> The Tenth Amendment reserves to the states powers not delegated to the United States by the Constitution. The United States has the power to regulate the interstate securities market, however, including the interstate securities market in municipal bonds.

In the closely related case of *South Carolina v. Baker*, the Supreme Court opined that Congress had authority to prohibit bearer bonds, whether issued by states or private issuers.<sup>260</sup> According to the Court, the Tenth Amendment might only be implicated if the federal legislation "commandeer[ed]" the states by "seek[ing] to control or influence the manner in which States regulate private parties."<sup>261</sup> This is not the case with respect to municipal issuer disclosure, at least when they are imposed as a condition for using national securities markets, rather than direct interference with state accounting.<sup>262</sup> More importantly, increased disclosure would support state democratic processes. The information generated by increased disclosure would help voters and other politicians assess the fiscal impact of politicians' actions.

#### CONCLUSION

In conclusion, we readily admit that our proposal is a long shot. We expect strong resistance by GASB and state politicians, and obtaining Congressional action is difficult. Nevertheless, the size of the financial accounting problem warrants exploration of solutions, even those with a low likelihood of success. Besides, our proposal for improved financial reporting

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257. Art Durnev & Claudine Mangen, *Corporate Investments: Learning from Restatements*, 47 J. ACCT. RES. 679 (June 2009).

258. See Welch, *supra* note 43.

259. See Amdursky & Gillette, *supra* note 239, at § 6.2.

260. 485 U.S. 505 (1988).

261. *Id.* at 514.

262. See, e.g., AMDURSKY & GILLETTE, *supra* note 239, at § 6.2 (pointing out that the court in the later case of *New York v. United States*, 505 U.S. 144 (1992), distinguished regulations "imposed directly on states," which might be problematic, from "regulations applied to states as well as others engaged in similar activities," which are not, and that this distinction would remove federal securities regulation from Tenth Amendment scrutiny).

invites less resistance than alternatives, such as reforms of state budget rules. We hope this Article has illustrated that improved reporting in itself is an important step toward fiscal recovery. We hope that SEC oversight of accounting by municipal issuers will be high on the list of candidate reforms when the next bankruptcy of a state or major city prompts Congress to reexamine municipal finances.